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PROPOSALS TO CHANGE MILITARY RETIREMENT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON MANPOWER AND PERSONNEL

OF THE

COMMITTEE ON ARMED SERVICES UNITED STATES SENATE

NINETY-NINTH CONGRESS

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PROPOSALS TO CHANGE MILITARY RETIREMENT

WEDNESDAY, DECEMBER 4, 1985

U.S. SENATE,
COMMITTEE ON ARMED SERVICES,
SUBCOMMITTEE ON MANPOWER AND PERSONNEL,
Washington, DC.

The subcommittee met in open session, pursuant to notice, at 1:37 p.m., in room SR-232A, Russell Senate Office Building, Senator Pete Wilson (chairman) presiding.

Present: Senators Wilson, Nunn, Exon, and Glenn.

Staff present: Patrick A. Tucker, counsel; Arnold L. Punaro, staff director for the minority; Russell C. Miller and David S. Lyles, professional staff members; Patricia L. Watson, research assistant; and Mary J. Kampo, staff assistant.

Also present: Dale F. Gerry, assistant to Senator Cohen; Mark J. Albrecht, assistant to Senator Wilson; Allan W. Cameron, assistant to Senator Denton; Gregory B. Craig, assistant to Senator Kennedy; and Phillip P. Upschulte, assistant to Senator Glenn.

OPENING STATEMENT BY SENATOR PETE WILSON, CHAIRMAN

Senator WILSON. Good afternoon, ladies and gentlemen.

This hearing will come to order.

We are advised that Senator Glenn, the distinguished ranking member, is en route to the subcommittee, but since we are a bit late starting, you were on time, we will not wait further.

The subcommittee meets today to conduct the first of two hearings on proposals to restructure the military retirement system. The second hearing on this subject will be conducted tomorrow, Thursday, December 5, at 1:30 p.m., in this same hearing room.

These two hearings are the logical second step required in the subcommittee's efforts to determine whether the military compensation system, not just the retirement system, but the compensation system as a whole, can be made more efficient by restructuring the fewer compensation dollars which are to go to military retirement, thereby freeing up dollars to be used to pay our military personnel serving on active duty.

During deliberations on the 1986 defense authorization bill, this subcommittee recommended that approach and the Congress followed it. By reducing the level of dollars authorized to be obligated in fiscal year 1986 for the future cost of military retirement by $2.9 billion, it was possible to fund a full year pay raise for military per-

sonnel as well as a large number of improvements in travel and transportation benefits and in special and incentive pays.

I think such a restructuring is appropriate in light of the changing demographics of our forces. Today more than half the active duty enlisted Army and 75 percent of the officer personnel of the Army are married and have a family. This is a substantial percentage increase in the number of married personnel in the Army since 1948 when the basic structure of the present military retirement system was enacted.

Our military families have a greater need and desire for compensation during their active duty careers than has ever before been the case. The Army experience we think is replicated pretty much throughout the services.

It is important at the outset of these hearings to make it clear what this effort does represent and also what it does not represent.

First, this effort on the part of the subcommittee does not, and I repeat and underscore does not, represent an erosion of support by the American people. nor specifically by this subcommittee, for our military personnel and their families.

Very much to the contrary, this effort is designed to strengthen the support which the American people expect and demand be given to our military forces.

Second, this effort is not designed to reduce the size of our combat forces by indirect means. It is not an effort that is intended to result in a degradation of readiness.

Rather it is designed to make more effective use of limited compensation dollars to ensure that no reduction in our ranks will occur in the future.

Finally, this effort should not be viewed by anyone as an effort to unduly constrain the defense budget. I think that should not need saying, not only for myself, but for, I think, the membership of this entire subcommittee.

Any who are familiar with my own views on the need for a strong defense, I think, will realize that I have not favored and, in fact, have stoutly resisted any precipitous cuts in the defense budget.

Let me only say that those who argue specifically, those who contend that restructuring the military retirement system would be an indication of the lack of support for our military personnel ignore the record of the members of this subcommittee and I think that they would unwittingly and perhaps unintentionally do a disservice not only to the members of this subcommittee, but, frankly, to the effort that is required.

If there is anyone sitting in this room who wonders why we are considering this, why the 1986 authorization bill imposed on the Department the requirement to respond to various alternatives for the reduction of the retirement system, I can only say that they apparently are living in splendid isolation of the unfortunate realities that are imposed on those who sit on this side of the rostrum and those who vote on the floor of the Senate and the floor of the House.

We are, as I think everyone in this room understands, constrained by budget considerations that are not of our liking, but they are not considerations that we can ignore.

One other matter should be brought to the subcommittee's attention and that is the very real need for us to act expeditiously on this matter. The 1986 defense authorization bill caps expenditures for the future costs of military retirement at a level of $2.9 billion below that required to be expended under the existing entitlement law.

I note, General Chavarrie, that your testimony makes that point and seeks relief, and quite appropriately.

Because of the present force size, the pay level each month that we fail to act results in an obligational deficiency of $241,667,000.

Furthermore, both the Senate and the House reported versions of the defense appropriations bill would provide appropriations for future military retirement cost at a level of $2.9 billion below that needed under existing permanent law. Each month that we fail to act on retirement reform—or if you do not regard it as reform, at least restructuring—will put the Department further in deficit with respect to the existing requirements.

At the present time there is only one option available to the Department of Defense in order to avoid an Anti-Deficiency Act violation. That option is to begin reducing the size of the force and that clearly was not the intent of this subcommittee.

We, therefore, must move with a degree of speed to resolve these issues. I think we must make every effort to reach decisions in the next 2 weeks and move the bill to the floor before recess which either all is military retirement or restores authority to the Department to fund retirement at the present levels or somehow if we are unable to come to grips with either choice, then we are faced with the reality that the services, themselves, to avoid that Anti-Deficiency Act violation, must reduce force levels.

These decisions clearly have substantial impact. The Defense appropriations bill that now perhaps will not receive floor action, but be melded into the continuing resolution is, obviously, the last effort, the last opportunity, I think, for us to act expeditiously to avoid these highly undesirable consequences.

Today we will hear from witnesses from the Department of Defense and from the Coast Guard. These witnesses will be focusing on the two proposals to alter military retirement which have been prepared by the Department of Defense in response to the statutory requirements of the defense authorization bill.

Our witnesses are first, Lt. Gen. Edgar Chavarrie, U.S. Air Force, Deputy Assistant Secretary of Defense, Military Manpower and Personnel Policy.

Representing the Army, Lt. Gen. Robert M. Elton, Deputy Chief of Staff for Personnel.

Representing the Navy, Rear Adm. Dudley Carlson, Deputy Chief of Naval Operations, Manpower, Personnel and Training.

Representing the Air Force, Lt. Gen. John A. Shaud, Deputy Chief of Staff for Personnel.

Representing the Marine Corps, Lt. Gen. E.C. Cheatham, Jr., Deputy Chief of Staff for Manpower.

And representing the Coast Guard, Rear Adm. Henry H. Bell, Chief, Office of Personnel.

Gentlemen, we welcome your here this afternoon. Your formal statements will be entered into the record.

To assure time for questioning, I would ask that you limit your oral statements to no more than 15 minutes. Do not feel constrained to take that amount of time if you can be more concise.

Additionally, during questioning we will operate under the 10-minute rule, at least during the first round of questions.

I will now ask if my distinguished colleague, and the ranking member of this subcommittee, Senator Glenn, has an opening statement to make?

Senator GLENN. I do, indeed, Mr. Chairman. Thank you.

I apologize for being late. I had a phone call come in just as I was leaving to come over here.

I want to join you in welcoming the witnesses this afternoon as we begin 2 days of hearings on the military retirement reform proposals.

I want to indicate my support for the chairman's call for prompt action on this matter. I will do everything I can to work with the chairman to act on this legislation.

One reason we need to act promptly is that there is a lot of interest in this legislation among the troops out in the field. I do not need to tell you gentlemen that. If there is any uneasiness out there about what Congress will do to this legislation, let me repeat again the commitment Congress made earlier this year, a commitment that any changes to the military retirement system will be prospective only.

I can tell you right here and now, I give you my pledge, that I will very strongly oppose any attempts in this legislation to reduce the future retirement benefits of anyone in the service today or anyone currently retired. To me that would be an absolute breach of faith concerning what people signed up for, people under your commands, people in your respective services signed up for.

They have a trust, it is a pact with their Government. To now say you served part of the career, now we are going to cut you off at the knees, to me is about as unfair as any proposal I have seen. We have had proposals made to this committee to do just exactly that.

Another reason we need to act promptly is because of the impending fiscal problem in the military personnel accounts. In fiscal year 1986 and the 1986 Defense Authorization Act, Congress put a legal ceiling on the amount of money that could be obligated for basic pay and military retirement accrual costs in fiscal year 1986 that is $2.9 billion below the budget request.

We have to make changes in the military retirement system to save this amount in retirement accrual costs or take other legislative steps to remove or revise that ceiling. We have not left ourselves much choice in the matter. We have to act one way or another.

As you know, Mr. Chairman, I have opposed as strongly as I could the provision in the fiscal 1986 Defense Authorization Act that reduced this year's budget for military retirement accrual costs.

I am not opposed to a thorough review and probable revision of the military retirement system. I do not want to be forced, and do not want to be forced now, to decide about a specific dollar or per-

centage reduction without first examining the impact of such a reduction on the services' ability to man their forces.

I will say here in public today I think that was one of the dumbest things we did. We just get our manpower ituation halfway stabilized and operating accounts up halfway to what they should be for ammo and things like that, shells, missiles, and so on, get them up and all at once we think those things can be cut. I think that is just the wrong way to do it.

For some other committee or even our committee to whack off a figure here of $2.9 billion and say that has to come out of your manpower accounts, or so on, and do it somehow, I think is an irresponsible legislative proposal. I was against it then, I am against it now. I do not think that is the way we should be setting our priorities.

As we begin our review of these proposals, I want to make clear that I do not feel bound by any specific dollar or percentage figure. I think it would be a mistake for us to feel that any legislation we enact has to achieve this $2.9 billion savings target exactly, no matter what the implications would be in your services.

During the debate on the 1986 authorization bill, I indicated I was in favor of changing the military retirement system as long as we honored our commitments to those serving in uniform today and to those currently retired.

We need to find ways to reduce the overall cost of the military retirement system, at the same time encourage some people to stay in service longer. That is a difficult combination to hook up.

The proposals we have in the Defense Department are a promising start. Before we attempt any proposals, we need to be able to answer yes, I believe, to each of the following questions:

Is the proposal simple enough so that it is readily understood by everybody, so that they know what their benefits will be at the end of their military career?

Will the military services still be able to man the forces with the type people and at accepted levels of numbers of people?

Will the proposal continue to provide a fair retirement system for military members that recognizes the unique aspects of a military career?

This is not sitting in a bureaucratic position in Civil Service in Washington for a full career and retiring and expecting the military to do the same thing and get exactly the same benefits and nothing more. We cannot expect our people to do that. It is a specialized and unique career. We need to take that into account.

Will the proposal result in cost savings to the Government over the current system?

These are the overall questions I will be focusing on during our review of this issue.

I look forward to working with you, Mr. Chairman, in addressing this legislation promptly in, I will stress, a bipartisan manner. Let me underline that. I do not think this should be a Democrat or Republican function. This is something that is going to be for the long haul for the United States of America and we had better do it right when we are doing it. I think it should be on a bipartisan basis.

Thank you.

Senator WILSON. Thank you, Senator Glenn. Your comments on the prospective application of whatever the committee does I think is not only well taken, but that much is established already.

We are, in this subcommittee, very clearly on record as vehemently opposed to any retroactive change. I think the breach of faith comment is altogether appropriate and we intend to honor that as an article of faith.

Senator Nunn?

Senator NUNN. Thank you very much, Mr Chairman.

I have no statement. I want to emphasize that I agree with the thrust of your opening remarks and the remarks of Senator Glenn.

I think the time frame under which this proposal has to be considered is unfortunate. It is an important matter. It is very difficult to deal with it under the best of circumstances, but in the last two weeks of the legislative session, it is going to be extraordinarily difficult.

The only way it can happen in a responsible way is with a bipartisan approach. I know most of the members of the committee are going to be looking to you and Senator Glenn for your determination and your guidance.

I think the full committee and the Senate itself will be prone to follow the guidance of this subcommittee, although nothing is guaranteed in the legislative process.

I will participate to the extent I can. We also have hearings on reorganization going on which require my participation. I will be in and out.

You have a tough job. The Defense Department has undertaken a comprehensive study. We have had 10 or 15 studies on retirement over the years. There is no shortage of suggestions. There will be a shortage of consensus.

The whole question of the effect of changes, based on my experience and your role, Mr. Chairman, is a very subjective judgment. It is very subjective to try to determine what the retention effect will be and what the overall effect on morale in the military forces will be because of changes, particularly changes that are prospective in nature, that do not affect people in the service today, but do affect people in the service tomorrow.

It is a difficult job. I will pledge to work with you and Senator Glenn and our distinguished panel and the people they represent.

Senator WILSON. Thank you, Senator Nunn. I appreciate that statement of support. The only thing I would appreciate more is if you had solved this problem when you were Chairman.

Senator GLENN. I just want to point out Senator Nunn's service on this committee. He sat in the seat I now occupy. He goes back a long way on these matters. I would encourage you, Sam, to attend these meetings and be with us on these things because you have a longer history of dealing with them than any of us here.

Senator NUNN. I want this to be named the Wilson-Glenn bill. [Laughter.]

Senator WILSON. John, I begin to get the feeling that was not entirely an oversight.

Senator NUNN. We did do the high three while I was Chairman. That is the only fundamental reform in the retirement system and it, too, was prospective in nature. I think a lot of the DOD propos-

als are weighed against not only the current system, but the high three.

That means the high 3 years of pay will be the basis of retirement rather than the last day. That is a very important feature that is going to be played off in here in terms of the fiscal effects of any of these proposals.

Senator WILSON. Senator Kennedy has requested that his prepared statement be made a part of the hearing record.

[The prepared statement of Senator Edward M. Kennedy follows:]

PREPARED STATEMENT BY SENATOR EDWARD M. KENNEDY

Mr. Chairman: The topic that we are taking up today—military retirement reform—is a matter of intense interest and concern to the men and women in our armed forces today. That interest and concern is understandable, but they should know that any change in the military retirement system will apply only to those who enter the military in the future; the lives and plans of the people presently in the military will in no way be affected by what we might or might not do in Congress. That commitment has already been made, and it will be respected.

But our system of retirement for the future will clearly have an important impact on our military personnel in the future. Our nation's ability to defend itself depends in the first instance upon our nation's fighting forces, and we need to be able to attract the very best people our nation has to offer to join the military as a career. And we need to be able to retain them once they have joined the military.

Our armed forces must have young and able and vigorous men and women who are willing and eager to commit themselves to the military profession, and in that regard, the issue of military retirement—and how we change or reform that system—is vital to our national defense.

The real question is whether our system of military retirement can be reformed without jeopardizing our ability as a nation to maintain a high quality, young and vigorous standing military. Initially, military retirement was designed and intended to operate as a system of "deferred compensation"—to make up for the disparity between civilian levels of compensation as compared with military pay and to serve as an incentive to keep people in the service until they were eligible for retirement.

But today, we have worked hard to make military pay comparable with civilian pay, and the needs of the men and women in uniform may be different. Today, when such a high percentage of our military personnel are married, it may be that our money is better spent during the earlier years of military service—when the military family is in need of maximum support—than for retirement after twenty years of service has been completed.

Military service is different from civilian employment, and the military way of life is no longer limited to the man or the woman in uniform. The military way of life now includes more than ever before the military family—the wives and children of so many of our service men who share the burdens and sacrifices of serving the nation in our armed forces. By restructuring our retirement system, we may be able to provide more benefits to our men and women in uniform—and to their families—at the time they need it most.

It is true that our men and women in the military make unique, dangerous and vital sacrifices—and it is also true that they deserve to be compensated fairly for those sacrifices.

It is also vital to our national defense. I have often said that I believe that the people in the military are the most important weapon system that we have. The combination of benefits that we provide those people—in the form of direct compensation, health care, bonuses, commissary privileges and retirement—must be right if we are going to keep that weapon system strong, modern, tough and in good operating condition.

And like any other weapon system, this one should be as efficient and as cost-effective as is possible. We spend $36.6 billion on compensation for our service personnel and $18.2 billion on retirement. The question is whether it is most efficient and cost-effective for such a high percentage of our total compensation dollars to be dedicated to retirement benefits or whether another and different mix is warranted.

I look forward to hearing the testimony from these witnesses and to examine the two proposals that they have, albeit reluctantly, come up with. We will have to make a decision on this soon.

Senator WILSON. General Chavarrie.

STATEMENT OF LT. GEN. EDGAR A. CHAVARRIE, U.S. AIR FORCE, DEPUTY ASSISTANT SECRETARY OF DEFENSE (MILITARY MANPOWER AND PERSONNEL POLICY)

General CHAVARRIE. Thank you, Mr. Chairman.

We appreciate the opportunity to be here so that we can present our views. May I say we welcome very much your comments on that legislation regarding the funding problem that we have to face.

I will just summarize my statement and will conform to your 15 minute rule.

Sir, as you know, the Secretary of Defense was instructed to submit a report to include legislative drafts of two options for changing the retirement system for future entrants. One option was to effect changes to the system other than through the alteration of cost-of-living adjustments. The second was not constrained in that way.

Other requirements included the assessment of the effect on force manning for each of the two options, advisability of a transition plan, comments on adjustments to other personnel or compensation policy that might be required should retirement benefits be reduced, and an analysis of other specific retirement system modifications that would yield from 1.8 up to 5.4 in accrual reduction.

Before I make a quick summary of each of the parts of that report, may I just say, to emphasize what Secretary Weinberger stated when he transmitted the report to Congress, that the Department of Defense does not support either of those two options for change.

The options that meet the $2.9 billion criterion were submitted only to comply with the statute. We remain very concerned about the negative effect of a 16-percent reduction to the lifestream value of retired pay, which is what the 2.9 would be in military retirement, and what effect it would have on the long-term viability of our career forces.

Certainly Senator Nunn's comments about subjectivity, because it is all in the future, creates an even more difficult problem for all of us. Although the changes are prospective and are grandfathered, there is evidence of concern. The services have some early statistics, particularly General Elton, that there is concern among the current force that current benefits are not necessarily guaranteed from erosion irrespective of our commitments to grandfathering both the active force and retired force.

It is strictly a perception, and it is subjective. Sometimes, however, perceptions are more important in fact than when they are prospective. We fear perhaps this perception could result in a near-term down-turn in retentions.

With those qualifications, sir, may I just summarize the report in a few sentences on each section.

The first section provides background information on the retirement system as it exists now and summarizes some events leading up to the submission of the report. It discusses the unique nature

of military service and the uniqueness and the institutional nature of military retirement.

It discusses the reduction in retirement pay for members entering the military after September 8, 1980; that is, the high three, and the change to accrual accounting for military retirement beginning in fiscal year 1985.

The second section describes the two options we are providing in the form of draft legislation. One, of course, is a structure-only change that reduces the current structural multiplier of 2½ percent per year, to 2.15 percent for each year up to 20, and 3.2 percent for each year from 20 to 30 and changes the retired pay calculation from the high 3 year average to a high 5 year average. This option preserves the COLA adjustment at the full CPI increase.

The second option is what we call a combination option. It includes a multiplier reduction plus a COLA change and adjusts the multiplier to 2.2 percent for each year up to 20, and 3.1 percent for each year between 20 and 30. This option limits COLA to the CPI change minus one for life with a one-time restoral at the 40th anniversary of initial entry into service. At that point the retired pay is recalculated at the 40th anniversary to the amount to which the individual would have been entitled had his original retired pay been fully indexed.

Both options are fully grandfathered.

The third section discusses the anticipated effects of the two options on force readiness. Included are discussions on retention and recruiting, and analysis depicting the degradation in experience levels based on 5th QRMC moves, as requested by the Congress. The models show an 8- to 12-percent reduction in the 10- to 20-year portion of the force and 16- to 37-percent reduction in the 21- to 30-year portion of the force.

As we have noted in our report, the retention assumptions used in the model are identical to those used in the 5th QRMC analysis which the Secretary of Defense sent to the Congress. The retention rates used in the model are based on the average retention data that we have over a 7-year period from 1976 to 1982. Current retention behavior has, of course, improved since then due to the support of this committee and the Congress for other benefits in pay and allowances to our military members.

If one were to assume that the current retention rates, which are about the best rates we have had in a very long time, are the best estimates of retention in the long run, then one could submit that the effect on the career force of the retirement changes, in absolute terms, would be less than we have projected in our model. Alternatively, if one were to use worst-case retention rates, the effect on the career forces would be worse than projected. The material presented in this section is the basis for the discussion in section 6 of the four other levels of reduction that we were required to address reductions from $1.8 billion up to $5.76 billion.

The fourth section addresses the requirement for a transition plan that could be used to phase in either of the two options over a period of 4 years or more. We have taken the position that a transition would be inappropriate because it would create at least four other categories of people with different benefits. We already have two, the final pay and high three groups. We would have another

for whatever the retirement change would be, and another group of people that would be under various categories of retirement systems, depending on how the transition plan actually was effected. Further, it would take a substantially more drastic reduction in benefits to achieve the mandated $2.9 billion cut in fiscal year 1986 because a phase in would allow partial credit in the first year. An established cutoff point is preferred; that is, when the legislation is passed, that is the new system instead of having a transition plan. It would be terribly complicated, and the fourth section discusses the pros and cons of that.

The fifth section discusses other compensation implications of a cut in retirement benefits. Specifically, it points out that substantial increases would be required in other elements of the military personnel budget, such as in retention and recruiting bonuses and other forms of up-front compensation if the required force structure is to be sustained. In addition, we point out the necessity for keeping a fair and competitive pay level comparable to the private sector pay upon which these added incentives would have to be based. The complexities of defining specific requirements, given these real life uncertainties, are recognized and discussed in the fifth section.

The sixth and last section addresses the five specific levels of reduction from $1.8 to $5.4 billion. They are discussed in the same context and use the same analyses discussed on the two options that result in the mandated $2.9 billion reduction. We used the fifth QRMC models to describe the specific force changes and show how very slight changes in economic assumptions could dramatically multiply the negative effect on the force or, present a more positive picture, as the case may be.

We know and understand the effect of the current system. We can only speculate in relatively uncertain terms on individual reaction to the very large reductions (30 percent in the $5.4 billion case) in retired pay that are proposed.

Mr. Chairman and members of the subcommittee, that summarizes our report sent over by the Secretary of Defense, I think we have stated our views objectively, but certainly in accordance with the statute and in accordance with the directive that you mandated to us regarding the $2.9 billion reduction, and the impact of the two options.

I would like to note here that you have previously received testimony from the Department of Defense on this crucial issue to our national security. The gist of the testimony was that the current system, in concert with other elements of compensation and force management policies, has produced a combat-ready force. Any changes to the current system must be considered in this light.

Also, may I remind the subcommittee that current military retirement is not overly generous or too costly. Sixty-four percent of our enlisted retirees draw annuities below the poverty level for a family size of four and funding for retirement accrual is less than 25 percent of the military personnel budget, about 6 percent of the defense budget.

It seems, then, that the current price for assuring our combat readiness is not inordinate when you consider it in these terms. I

am sure you will take these views into account during your deliberations.

May I just say one word, Mr. Chairman, with regard to your comments on the legislation?

I will not read the text, but I will say that we welcome very much your cognizance of that and the difficulties that we are going to be faced with in a very short time regarding a change and regarding the function of that $242 million a month.

We urge immediate consideration and we welcome again, may I say, your immediate consideration and passage so that we will not have to do anything about end strength.

That concludes my statement, sir.

Thank you very much.

[The prepared statement of General Chavarrie follows:]

PREPARED STATEMENT OF LT. GEN. E.A. CHAVARRIE, USAF, DEPUTY ASSISTANT SECRETARY OF DEFENSE (MILITARY MANPOWER AND PERSONNEL POLICY)

Mr. Chairman and Members of the Committee: I appreciate the opportunity to appear before you to discuss the report on military retirement we recently submitted to the Congress in response to the requirement in the fiscal year 1986 Defense Authorization Act.

The Act limited the authorized obligations for the funding of military basic pay and retirement accrual. For fiscal year 1986, funding authorization was cut by $2.9 billion. The Secretary of Defense was instructed to submit a report to include legislative drafts of two alternative options for changing the nondisability retirement system for future entrants that would each independently achieve the required reduction. One of the options was to effect changes to the system other than through alteration of the procedure for periodic cost-of-living adjustments; the second was not similarly constrained. Other requirements included an assessment of the effect on force manning of each option, the advisability of a transition plan, comments on adjustments to other personnel or compensation policies that would be required should retirement benefits be reduced, and analyses of other specified retirement system modifications that would yield from $1.8B to $5.4B in accrual reductions.

Before summarizing the contents of the report, I want to emphasize, as Secretary Weinberger did in transmitting the report to the Congress, that the Department of Defense does not support either option for change. The options were submitted only to comply with statute. We remain vitally concerned about the negative effect a 16 percent reduction in military retirement would have on the long-term viability of our career forces. Even though the changes are prospective only and current personnel are grandfathered, there is evidence of concern among the current force that current benefits are not guaranteed from erosion. This perception could result in near-term downturns in retention.

With these qualifications, let me briefly summarize the report we sent to you. The report is organized into six sections as follows:

The first section provides background information on the military retirement system and summarizes events leading to the submission of the report. This section discusses the unique nature of military service and the institutional nature of military retirement; the reduction in retired pay for members entering the military after September 8, 1980, because of the high-three-year average calculation of retired pay—a 13 percent cut; the change to accrual accounting for military retirement beginning with fiscal year 1985; and the recent events resulting in this hearing today.

The second section describes the two options we are providing in the form of draft legislation. One is a structure-only change that reduces the current 2.5 percent per year multiplier (to 2.15% for each year up to 20 years; 3.20% for each year between 20 and 30 years) and changes the retired pay calculation from the high-three-year average to a high-five-year average. This option preserves the COLA adjustment at the full CPI increase. The second is a combination option (multiplier plus COLA change) that adjusts the multipliers (2.20% for each year up to 20 years; 3.10% for each year between 20 and 30 years) and limits COLA to the CPI change minus one percentage point for life with a one-time restoral at the 40th anniversary of initial entry into service (retired pay is recalculated at the point of restoral to the amount

to which the individual would have been entitled at that point had his original retired pay been fully indexed). Both options are fully grandfathered.

The third section discusses the anticipated effects of the two options on force readiness. Included are discussions on retention and recruiting and analyses depicting the degradation in experience levels based on 5th QRMC models, as requested by the Congress. The models show an 8 to 12 percent reduction in the 10 to 20 year portion of the force and a 16 to 37 percent reduction in the 21 to 30 year portion of the force.

As we have noted in our report, the retention assumptions used in the model are identical to those used in the 5th QRMC analyses. The retention rates used in the model are based on average retention over the seven-year period 1976 to 1982. Current retention behavior has improved since then. If one were to assume that current retention rates are the best estimates of retention in the long run, then one could submit that the effect on the career force of the retirement changes in absolute terms would be less than projected. Alternatively, if one were to use worst case retention rates, the effect on the career force would be worse than projected. The material presented in this section is the basis for discussion in section 6 of the four other levels of reduction we were required to address.

The fourth section addresses the requirement for a transition plan that could be used to phase in either of the two options over a period of four years or more. We have taken the position in this section that a transition would be inappropriate because it would create at least four other categories of people with different benefits (we already have two—those under final pay and those under high-three-year averaging). Further, it would take a substantially more drastic reduction in benefits to achieve the mandated $2.9B cut in fiscal year 1986 because a phase-in would only allow partial credit in the first year. An established cut-off point is preferred if any change is made.

The fifth section discusses other compensation implications of a cut in retirement benefits. Specifically, it points out that substantial increases would be required in other elements of the military personnel budget, such as in retention and recruiting bonuses and other forms of up-front compensation, if the required force structure is to be sustained. In addition, we point out the necessity for keeping a fair and competitive pay level comparable to private sector pay upon which these added incentives would have to be based. The complexities of defining specific requirements given the real-life uncertainties are also recognized.

The sixth section addresses the five specified levels of reduction ($1.8B, $2.9B, $3.6B, $4.0B, and $5.4B) in the same context as the discussion of the two options that result in the mandated $2.9B reduction. We use 5th QRMC models to describe the specific force changes and show how very slight changes in the economic assumptions could dramatically multiply the negative effect on the force or alternatively present a more positive picture. Our point is that we know and understand the effects of the current system and that we can only speculate in relatively uncertain terms on individual reaction to the very large reductions (30% in the $5.4B case) in retired pay that are proposed.

Mr. Chairman and members of the Committee, that summarizes the content of our report. I believe we have stated our views objectively and in accordance with the directions of the Congress.

I would like to note here that you have previously received testimony from the Department of Defense on this very crucial issue to our national security. The gist of the testimony was that the current system, in concert with other elements of compensation and force management policies, has produced a combat-ready force. Any changes to the current system must be considered in this light. Also, I wish to remind the Committee that current military retirement is not overly generous or too costly—64 percent of our enlisted retirees draw annuities below the poverty level for a family size of four, and funding for retirement accrual is less than 25 percent of the military personnel budget and about 6 percent of the Defense budget. It seems to me that the current price for ensuring our combat readiness is not inordinate when considered in these terms. I trust you will take these views into account in your deliberations.

Finally, I would like to call the attention of the Committee to the accrual funding aspects of a $2.9B reduction. Under existing law, the Department of Defense must contribute monthly increments to the retirement trust fund based on the actuarially determined future costs of the current system. The $2.9B reduction in funding and obligational authority for fiscal year 1986 was predicated on an October 1, 1985, effective date of change to one of the two options. In view of the timing of the enactment of the Defense Authorization Act and the current status of the action to change the military retirement system, the Department of Defense has proposed

legislation to obtain relief from these obligation limits on a monthly pro rata basis pending final Congressional action on military retirement. The Department of Defense urges immediate consideration and passage by the Congress to preclude unnecessary personnel turbulence.

Mr. Chairman, this concludes my prepared statement.

Senator WILSON. Thank you, General Chavarrie.

General Elton?

STATEMENT OF LT. GEN. ROBERT M. ELTON, U.S. ARMY, DEPUTY CHIEF OF STAFF FOR PERSONNEL

General ELTON. I welcome and appreciate the opportunity to appear before you and the subcommittee to present the Army position and views on the cost reduction in the military retirement system.

Let me say off the bat that the Army opposes any reduction in the retirement benefits. Reduction in military retirement benefits for future soldiers can have a dramatic impact on current and future force retention.

As we have found from surveys recently taken, and I will show these to you in a minute, today's career force perceives a change in the retirement system as yet another erosion of benefits. Soldiers perceive that projected decreases in retirement benefits are a first step and a strong threat to their own retirement benefits.

They are likely to believe that other benefits may also be possible candidates for reduction such as commissary or medical benefits.

When it is time to reenlist, some may decide to leave because of loss of faith and trust. They are also very likely to pass on their loss of faith and trust to subordinates who will not be grandfathered, as well as to society at large.

A recent survey indicates proposed changes to the retirement system is a key reason for not staying in the Army beyond 20 years of service. If you will open the gray folder on the desk in front of you, you will see the four charts.

FALL FISCAL YEAR 1986 REENLISTMENT SURVEY

Most important reason for not staying in the Army beyond 20 years:
At 20th yr more marketable in civilian world (28%).
Desire permanent residence (16%).
Proposed changes to retirement system (14%).
Time to do something else (6%).

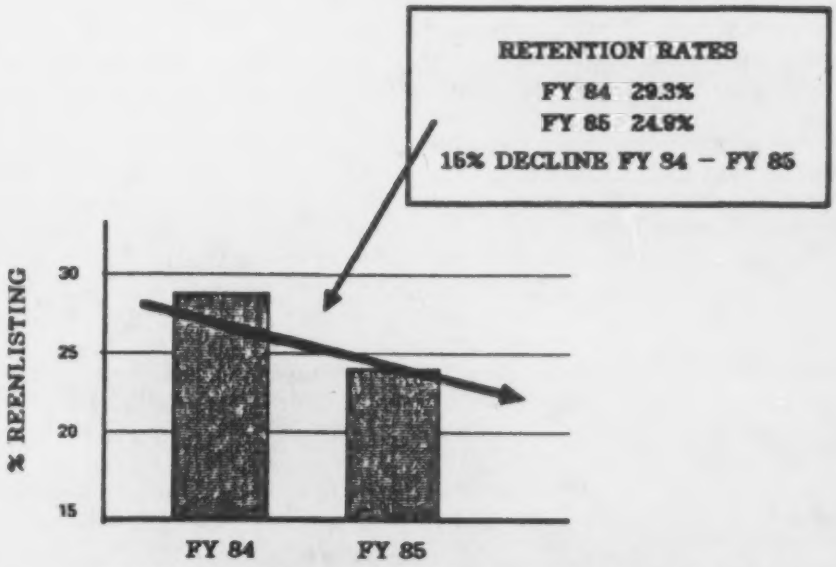
The first is entitled "Fall of Fiscal Year 1986 Reenlistment Survey." This particular survey was one that was just recently completed amongst 244 reenlistment noncommissioned officers, grade E-7 through E-9.

We noticed during the first half of fiscal year 1985 that the reenlistment statistics for our retirement eligible noncommissioned officers was dropping off in comparison to 1986. So, we asked these NCO's to find out from the retiring NCO's why they were leaving. This is data they have collected from talking to NCO's who actually retired rather than reenlist during the last two quarters of fiscal 1985.

You see there the third bullet down says, "Proposed changes to retirement system." Fourteen percent of the NCO's they talked with left the Army because of these proposed changes. They told

them the changes would not include them, that they would be grandfathered, and still the comments came back that, well, yes, we hear that, but, you know, we have ours now and we have been in 20 years and maybe it is time for us to walk.

RETENTION RATES OF RETIREMENT ELIGIBLE SOLDIERS



DROP IN RATES PARTIALLY ATTRIBUTED TO ACTUAL AND PERCEIVED LOSSES IN PAY AND BENEFITS

The second chart that I want to talk about shows you that dramatically in total numbers. It is entitled "Retention Rates of Retirement Eligible Soldiers" and compares the retention rate in fiscal 1984 to the rate in fiscal 1985.

It shows a dramatic increase from 29 percent, about 25 percent, 15 percent decline in actual numbers, that is, 2,800 down to 2,300. So, that is a drop and yet no one has signed the dotted line for any retirement reduction.

The first requirement of the retirement program is to maintain a young, vigorous and combat ready force capable of operating effectively and efficiently in both wartime and peacetime. The proper balance between youthful vigor and experience is required and the current system provides that balance.

Second, retirement compensation is reduced pay for reduced or delayed service and it supports a mobilization base of experienced personnel subject to recall to active duty during time of war or national emergency.

As of October 10, 1985, the Army retiree recall program had about 134,000 retirees who have orders in their hip pocket preassigned to 56 Conus mobilizations.

As a side note, it is interesting to note that this fall we successfully conducted a retiree recall test for 400 retirees who were voluntarily ordered to active duty at eight locations throughout the United States and every one of them showed up.

The third purpose of this retirement program is to establish the Army as a career which is financially competitive with civilian employment. We have made great strides in attracting high quality personnel into the Army.

However, a reduction in retirement benefits will have a greater impact on higher quality personnel and by that I mean those with a high AFQT, or Armed Forces Qualification Test category. They are generally more sensitive to compensation and economic factors than are those who are less qualified, as they have greater opportunities outside the service.

Reduction in compensation relative to civilian earnings could lead to lower retention rates, a smaller career force and one with lower quality people.

The impact on retention of the two options submitted by the Secretary of Defense to Congress was estimated, using Army models, which predict losses to the career force that are approximately twice as large as predictions of the fifth quadrennial review model.

PROJECTED ENLISTED FORCE STRUCTURE

	BASE	HI-5 MULT	COMBINATION
ACCESSIONS	128096	139561	138661
CHANGE	0	11465	10565
% CHANGE	0	9.0%	8.2%
0-4 YOS	378878	407[illegible]99	405280
CHANGE	0	28821	26402
% CHANGE	0	7.6%	7.0%
5-10 YOS	147577	140113	140745
CHANGE	0	-7464	-6832
% CHANGE	0	-5.1%	-4.6%
11-20 YOS	118363	101155	102451
CHANGE	0	-17198	-15902
% CHANGE	0	-14.5%	-13.4%
21-30 YOS	22192	18233	18534
CHANGE	0	-3959	-3658
%CHANGE	0	-17.8%	-16.5%
5-30 YOS	288122	259501	261720
CHANGE	0	-28621	-26402
% CHANGE	0	-9.9%	-9.2%
END STRENGTH	667000	667000	667000

MEASURED FROM HI-3 STEADY STATE

ASSUMES 5% INFLATION, 1.0% REAL INT RATE ON ACCRUAL AND 3% REAL DISCOUNT RATE

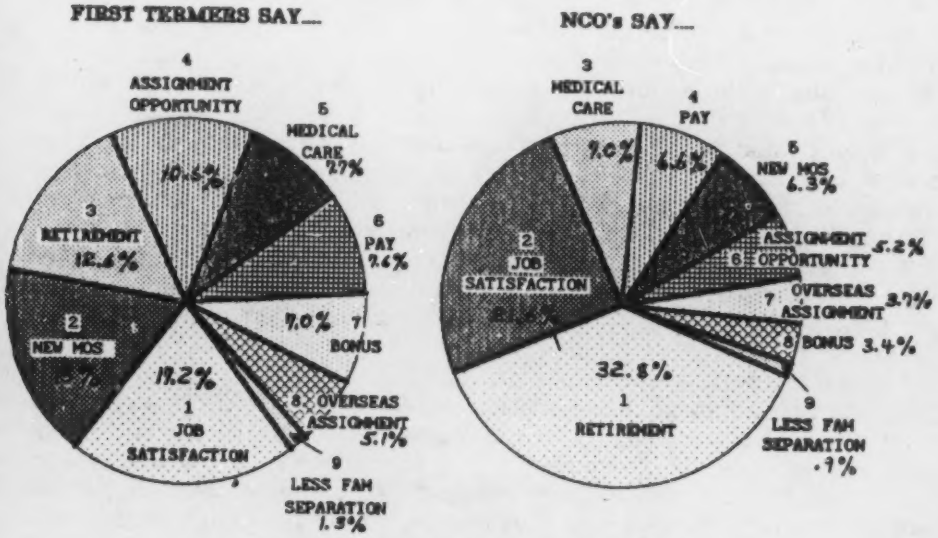
Senator WILSON. Would you repeat that last statement, General.

General ELTON. The impact on retention of the two options submitted by the Secretary of Defense to Congress was estimated, using Army models—these are primarily econometric models developed by personnal at the military academy—which predict losses to the career force that are approximately twice as large as the predictions of the fifth quadrennial review model.

That is primarily a differences in the projected individual sensitivities that are used as determined by the people using the model.

Our surveys have consistently shown that retirement benefits and job satisfaction are by far the two most important reasons why people reenlist.

FACTORS WEIGHING MOST HEAVILY IN REENLISTMENT



RESULTS OF FY 84 ODCSPER SURVEY

TOP NINE CATEGORIES (DOES NOT ADD TO 100%)

(4)

At this time I would like to call your attention to the fourth chart which is simply two pie-shaped charts which I showed to one of the committees earlier and I believe it was the Appropriations Committee, which shows that factors weighing most heavily in reenlistment—this is from a recent survey of over 17,000 soldiers conducted in late 1984—first termers said, 12.6 percent said that retirement is the No. 3 item which weighs most heavily in reenlistment.

These are first termers generally with less than 3 years of service. You can see for noncommissioned officers almost 33 percent or a third of them say retirement ranks as No. 1.

Therefore, reductions in retirement would have more impact on the career force.

Further, the 5th QRMC estimates were made based on data which assumes the current retirement system to be in effect. We really cannot assume this provides a current representation of behavior under a different and less valuable retirement system.

No one knows exactly how much the continuation rates will change after a major reduction in the retirement benefits. We do know that using estimates based on temporary changes in income and continuation rates in effect under the current retirement system will produce the very smallest and optimistic effect we can hope to observe.

We believe these are unrealistically optimistic expectations and losses could be larger than the 5th QRMC by a significant amount. We believe it would be imprudent to develop a policy based on those estimates. Even a modest decrease on continuation rates could have a severe impact on career force, increasing accession re-

quirements for the Army by 9 percent, for option one, and over 8 percent for option two, which is the multiplier plus COLA.

Career losses in the 5- to 30-year service group are expected to be between 9 and 10 percent. We expect a disproportionate loss of middle grade enlisted of about 15 percent in the 11- to 20-year group. This is the group that makes up the leadership and training cadres of the Army.

I should also point out that one of the major goals of the Congress in proposing the reduction in retirement is to encourage people to serve longer. What we must all remember is that you cannot hope to have people serve beyond 20 years if we cannot convince them to remain for 20 years in the first place. Our projected losses of about 15 percent in the enlisted 11- to 20-year service groups and 17 percent in the 21- to 30-year service group bear this out.

The retirement system is a fundamental part of the total military compensation package. If the retirement benefits are reduced, then offsetting increases in other elements of compensation will be required in order to reduce or offset the adverse impact on retention. This could include such actions as ensuring permanent full pay comparability with the civilian sector or providing significant increases in reenlistment bonuses or other incentive pays.

The Nation must offer a total compensation package which is competitive with the civilian sector if we are to maintain the size and quality force we need and if soldiers are to be financially able to adequately care for their families.

Uniqueness of the military profession and the requirement of national security clearly support a fair, equitable and competitive military compensation system, including retirement, which avoids serious personnel losses and protects readiness on a voluntary basis for manning the Army.

We believe that trying to adequately model and predict human behavior is extremely difficult. We do not know what the precise results of a retirement reduction will be, but we do know there may be losses in retention. We will, therefore, have to provide offsetting increases in other elements of the compensation package or settle for a degraded force.

Even if we are to settle for that degraded force, there could be increased accession and training and readiness costs to pay. We could not save the amount by which retirement is reduced and we would gamble with the stability and readiness of the Army. In our opinion, it is not worth the gamble.

Therefore, the Army requests no change be made to the current retirement system.

I am ready for your questions.

[The prepared statement of General Elton follows:]

PREPARED STATEMENT BY LT. GEN. ROBERT M. ELTON, DEPUTY CHIEF OF STAFF FOR PERSONNEL, U.S. ARMY

I welcome and appreciate the opportunity to appear before this committee to present the Army position and views on the cost reduction in the military retirement system directed by the 1986 Defense Authorization Act.

The legislative proposal submitted by the Secretary of Defense includes two options, each of which would result in the mandated $2.9B reduction. Option 1 is a change in structure which would reduce the percentage multiplier for each year of

service. It would also use a high-five year average of base pay in calculating retired pay. This option is predicated on the assumption that full cost of living adjustments (COLA) would be provided annually. Option 2 would reduce the multiplier and also decrease the annual COLA. The Army opposes enactment of either option.

Reduction in military retirement benefits for future soldiers can have a dramatic impact on current and future force retention. As we have found from surveys, today's career force perceives a change to the retirement system as yet another erosion of benefits. Soldiers perceive projected decreases in retirement benefits as a "first step" and a strong threat to their own retirement benefits. They are likely to believe that other benefits may also be possible candidates for reductions; such as commissary or medical benefits. When it is time to reenlist, some may decide to leave because of loss of faith and trust. They are also very likely to pass on their loss of faith and trust to subordinates who will not be grandfathered, as well as to society at large. A recent survey indicates that "proposed changes to the retirement system" is a key reason for not staying in the Army beyond 20 years-of-service.

The current retirement system is a vital element of the total compensation package which includes: base pay, basic allowance for subsistence, quarters, and other housing allowances; the Federal income tax advantage derived from the nontaxable status of allowances; bonuses; and, various special and incentive pays. This package has been carefully constructed over the years to maintain readiness of the armed forces by supporting the service's personnel and manpower policies:

A. The first requirement is to maintain a young, vigorous and combat-ready force capable of operating effectively and efficiently in both wartime and peacetime. The personnel system accomplishes this through the growth of a steady flow of officers and enlisted personnel of the required quantities, skill and experience levels, and grades. Mandatory retirement enables the service to ensure this steady career progression by removing individuals who are no longer competitive for further advancement. At the same time, soldiers who are eligible for retirement and possess needed skills and talents are encouraged to remain on active duty beyond 20 years-of-service. A proper balance between youthful vigor and experience is required. The current system provides that balance. In today's combat environment, we need soldiers who are in superior physical condition, mentally sharp, and who can endure the rigors of the battlefield for extended periods. In 1985, 350 of the best senior noncommissioned officers in the Army participated in a study at the sergeants major academy. Sixty percent stated that they could not perform their current duties satisfactorily at age 50–55 in combat.

B. Secondly, retirement compensation is reduced pay for reduced or delayed service, and it supports a mobilization base of experienced personnel subject to recall to active duty during time of war or national emergency. The Army mobilization contingency plans include recalling to active duty almost 60 percent of eligible retired members. As of 10 October 1985, the Army retiree recall program had about 134,000 retirees preassigned to 56 CONUS mobilization stations. This fall the Army successfully conducted a retiree recall test for 400 retirees voluntarily ordered to active duty at eight locations throughout the U.S. The test provided an evaluation of installation procedures to notify, assign, utilize, and support recalled personnel.

C. A third purpose is to establish the Army as a career which is financially competitive with civilian employment. We have made great strides in attracting high quality personnel into the Army. However, a reduction in retirement benefits will have a greater impact on higher quality personnel (high AFQT category). They are generally more sensitive to compensation and economic factors than less qualified personnel, as they have greater opportunities outside the service. A reduction in compensation relative to civilian earnings could lead to lower retention rates and hence to a smaller career force and one of lower quality people.

The impact on retention of the two options submitted by the Secretary of Defense to Congress was estimated using Army models which predict losses to the career force that are approximately twice as large as predictions of the fifth quadrennial review of military compensation (QRMC) model estimates (10 percent versus 5 percent loss in the total enlisted career force). When the 5th QRMC model is run using current retention rates, the model predicts "steady state" force which is comparable to today's force. We disagree with the QRMC model on two accounts. First, the elasticities (which show the change in continuing in the service for a change in life earnings) used in the annual cost of leaving (ACOL) model of the fifth QRMC were estimated from temporary changes in reenlistment bonuses. However, a change in retirement is a permanent change in income and could be of much greater concern to people. People tend to be security conscious and quite sensitive to real or proposed changes in retirement benefits. Surveys have consistently shown that the retirement benefit and job satisfaction are by far the two most important reasons why

people reenlist. Therefore, reductions in retirement would have more impact on the career force. Further, the estimates of elasticity were made using data collected when the current retirement system was in effect. We cannot assume they are correct representations of behavior under a different and less valuable retirement system. No one knows exactly how much continuation rates will change after a major reduction in the retirement benefits, but we do know that using elasticities estimated from temporary changes in income and continuation rates in effect under the current retirement system will produce the very smallest and most optimistic effect we could hope to observe. We believe these are unrealistically optimistic expectations. Losses could be larger than fifth QRMC estimates by a significant amount and we believe it would be imprudent to develop policy based upon estimates which reflect these unrealistic best case projections.

Even a modest decrease in continuation rates, could have a severe impact on the career force increasing accession requirements for the Army by about nine percent for option one (multiplier only) and over eight percent for option two (multiplier plus COLA). Career losses in the 5-30 year-of-service group are expected to be between 9 and 10 percent. The Army personnel system is a closed entry program—meaning that mid and senior grade careerists leaving the system cannot be replaced by lateral transfers into the service or by new entry level accessions. A change to the retirement system could cause a disproportionate loss of middle grade enlisted and officer careerists (about 15 percent of the enlisted career force in the 11-20 year group). This is the group that makes up the leadership and training cadre of the Army. This loss could reduce the readiness of the Army. Units could also lose additional experienced NCO's and officers to recruiting and training duties which could exacerbate the loss and could further degrade readiness. We cannot afford such losses. Even if we assume that we could generate the increased accessions to fill the force in terms of raw numbers, we would have difficulty generating the same quality career force in terms of experience, to meet basic defense requirements. I should also point out that one of the major goals of the Congress in proposing the reduction in retirement is to encourage people to serve longer. What must be remembered is that you can't hope to have people serve beyond 20 years if you can't convince them to remain to 20 years in the first place. Our projected losses of about 15 percent in the enlisted 11-20 years-of-service group and about 17 percent in the 21-30 years-of-service group bear this out.

Under either option, using our model, Army accession and training costs are projected to increase by over $300M per year over the current costs. We might also have additional costs as a result of diminished efficiency and readiness caused by the lower quality and less experienced personnel. These cannot be accurately predicted but are nevertheless real. All of these additional costs would go toward offsetting and reducing the savings generated by the reduced retirement benefit.

The retirement system is a fundamental part of the total military compensation package. If the retirement benefits are reduced, then offsetting increases in other elements of compensation will be required in order to reduce or offset the adverse impact on retention. This could include such actions as: ensuring permanent full pay comparability with the civilian sector; or providing significant increases in reenlistment bonuses or incentive pays. The Nation must offer a total compensation package which is competitive with the civilian sector if we are to maintain the size and quality force we need and if soldiers are to be financially able to adequately care for their families.

The uniqueness of the military profession and the requirements of national security clearly support a fair, equitable and competitive military compensation system, including retirement which avoids serious personnel losses and protects readiness and the volunteer basis for manning the Army.

We believe that trying to accurately model and predict human behavior is extremely difficult. We do not know what the precise results of a retirement reduction would be but we do know that there may be severe losses in retention. We might, therefore, have to provide offsetting increases in other elements of the compensation package or settle for a degraded force. Even if we settle for the degraded force, there could be increased accession and training and readiness costs to pay. We could not save the amount by which retirement is reduced and we would gamble with the stability and readiness of the Army. It is not worth the gamble. The Army, therefore, requests that no change be made to the current retirement system.

Thank you, Mr. Chairman.

Senator WILSON. Thank you very much, General.

Admiral Carlson?

STATEMENT OF REAR ADM. DUDLEY CARLSON, U.S. NAVY, DEPUTY CHIEF OF NAVAL OPERATIONS (MANPOWER, PERSONNEL, AND TRAINING)

Admiral CARLSON. It is a pleasure for me to be here today. I really cannot add a great deal more, statistically, to what General Elton has said.

I would like to go on record as saying that the Navy, as well, shares the views of the Army in opposing any change in the military retirement system. It is readiness that we are concerned about. It is difficult to predict, as General Elton has pointed out.

We have various models, as well, in the Navy, and our computer programs indicate that we will see significant shortfalls in the career force should either of these two options be initiated. We view that as having only a negative impact.

Consider two men working side by side, one who happened to join a day later than the other. He knows—and don't you know that they are going to inform each other—that one of them in total life earnings makes $100,000 less than the other. Intuitively, that has to have a negative impact.

Senator WILSON. All of us felt that way about the seniority system. So, I understand the point you are making.

Admiral CARLSON. I would go on record as saying we are concerned with the serious impact on readiness that the changes in the retirement system would have and are also opposed to any change in the current retirement program.

Thank you.

[The prepared statement of Admiral Carlson follows:]

PREPARED STATEMENT OF REAR ADM. DUDLEY L. CARLSON, DEPUTY CHIEF OF NAVAL OPERATIONS FOR MANPOWER, PERSONNEL AND TRAINING

Mr. Chairman and distinguished members of the committee: It's an honor for me to appear as a congressional witness for the first time before the Armed Services Manpower and Personnel Subcommittee. This subcommittee has a consistent record of support for our military men and women. Today's high level of personnel readiness is a direct result of your initiatives to improve our sailors' quality of life. I acknowledge and congratulate you for your long term effort to provide a competitive pay and benefits package. I look forward to working with you in the future.

The proposed changes to the military retirement system have generated considerable debate. While much of the debate has illuminated the important issues at stake, some has been emotional, inaccurate, and downright misleading. It is clear to me, however, that the basic question is, "What impact will the mandated change have on the future readiness of our military forces?"

My answer is, it could be significant. When you're talking about retirement benefits, you're talking about readiness. Let me explain.

I think we can all agree that retainer and retirement benefits are basic elements of our total military compensation package. To this committee's credit, the overall value of that package has become increasingly competitive over the last five years. This trend was fortuitous. Inadequate pay and benefits in the late 70's had led to serious shortage of our experienced petty officers and officers. As you recall, poor recruiting and retention levels reduced personnel readiness to the point that our ability to adequately man our ships and aircraft squadrons was severely constrained. It took massive pay increases and other initiatives to arrest that dismal situation, and today's more competitive compensation package has almost eliminated our shortage of experienced personnel. However, you are now going to cut deeply into one of the bedrocks of that package, an element that has been in place and working well for over 35 years. It's clear to me that there is risk of a return to low readiness levels if you impose an unbalanced reduction on our sailors' lifestream earnings. There's no free lunch. If you take money from our sailors' pockets, they will vote with their feet. A reduction of any single element in the compensation

package—retirement in this case—will change the behavior of the people who are compensated. Fewer experienced personnel will lead directly to lower readiness.

You may ask what proof I have that reduced retirement benefits means reduced readiness?

We have computer models that can predict how our current force will react to compensation changes under a given set of assumptions. But then, those assumptions are always open to argument. The truth is, we don't know for certain how our force structure will suffer from a substantial cut to what has traditionally been a most valued and stable career incentive. For that reason I prefer to avoid arguments about computer projections and stick to what we intuitively know will happen if we reduce retirement benefits to the extent required by the FY-86 Defense Authorization Act.

The clearest way for me to evaluate the impact of the proposed cut in retirement is to look at what the cut will do to a retiring sailor's wallet. The largest number of Navy retirees are chief petty officers. An E-7 with 20 years of service could transfer to the Fleet Reserves and receive monthly retainer pay of $826 under today's retirement system. If the proposed retirement cut is enacted, the monthly retainer pay will drop to about $576, a 30 percent reduction. Assuming a poverty income level of $10,600 per year for a family of four, which currently exists, the chief's annual retainer pay would be 35 percent below the poverty line. His military lifestream earnings will decrease by about $95,000. Even assuming he embarks on a second career, his projected total lifestream earnings will be about 24% less than a civilian tradesman.

This chief petty officer has served in a profession that demands great personal and financial sacrifices and includes risks not normally found in civilian occupations.

Over his career, the chief has made numerous costly household moves. Often uprooting his family to travel thousands of miles to a new duty station. His spouse, if she worked outside the home, has had to accept low paying, entry-level jobs with each move because she was seldom in one location long enough to gain tenure. Further, the chief and his wife were frequently separated for 6 to 8 month periods while he deployed far away from home to serve our Nation. Finally, his family's transitory life has hampered his opportunity to build equity in a home of his own.

The chief, now at the end of an honorable career, must make a mid-life change at a time when his expenses are high and his marketable civilian skills may be few. Just to maintain his pre-retirement standard of living, he must initially earn about $23,000 a year in his civilian job—no easy task even in today's market place. Because his retainer pay is only about 23 percent of his total active duty compensation, not the oft quoted 50 percent, his required second career replacement income represents 77 percent of pre-retirement compensation.

Disregarding questions of individual equity, how many sailors will put up with the difficult conditions of a naval career when at the end they will receive only about $6,900 in annual retainer pay—especially considering that a shipmate who joined a few weeks or months earlier under a different retirement system will get $2,000 more each year. We are kidding ourselves if we think this will not be a controversial topic on the mess deck. I have no doubt that thousands fewer enlistees will stay for a career. And we will experience degraded personnel readiness. Hence, retirement is readiness.

In summary, because of the possible degradation in future combat readiness that can result from retirement benefit reductions, the Navy cannot support either of the proposed options for change. These options meet the dollar reduction, but emaciate our most valuable career force management tool. I echo Secretary Weinberger's concern that the losses of experienced officers and petty officers will return us to the unacceptable personnel readiness of the last decade.

I will be pleased to address your questions.

Senator WILSON. General Shaud?

STATEMENT OF LT. GEN. JOHN A. SHAUD, U.S. AIR FORCE, DEPUTY CHIEF OF STAFF FOR PERSONNEL

General SHAUD. I appreciate the opportunity to be with you this afternoon and first and foremost to support the views of my colleagues that we oppose in the Air Force any change in the retirement system.

Let me start on a positive note, if I could, that we certainly appreciate the recent congressional actions on behalf of the military, sir, and you mentioned those. I applaud the decision of this Congress to honor our present commitment by grandfathering members and those on active duty from any changes made in the retirement system.

I also recognize the recent efforts of this subcommittee to secure a pay raise for the military while Members of the Congress and Federal civilian salaries were frozen, and to lessen the burden of relocation of our members by recommending improvements in the PCS reimbursements.

Nevertheless, I am concerned with the detrimental effects that retirement cuts could have on both our present and future forces. Our present force could be affected by the implication of a perceived erosion of support by certainly a deficit-minded Congress.

Our future forces would be facing a reduction of another 16 percent on top of the 13 percent lost through the high three averaging in 1980. This results in over one-fourth less retirement pay. I cannot tell you precisely at what point cuts in military retirement would result in an irreparable loss of career incentive, although I feel strongly there is one.

My instincts tell me that this latest cut puts us dangerously close. I am concerned these proposed cuts will destroy the delicate balance of overall compensation and by failing to provide the proper mixture of career incentives, eventually will result in a lower quality military force.

You are deliberating what may be the most important legislation affecting the future of our Armed Forces for many years to come. I urge you to carefully consider the implications of reducing the future of the military retirement system through arbitrary cost reductions, as Senator Glenn has mentioned.

No mathematical model, no survey can tell you what you need to know, what is the most efficient and effective total compensation package for the military. Only observed behavior under a changing system can provide these answers. Unfortunately, the consequences of the wrong formula may be grave and risk the rebuilt quality of our military and national self-confidence which we have enjoyed these last few years.

We may not have the perfect system right now, but I firmly believe we are very close. The current system has stood the test of time through peace and war and has served us well.

Sir, this concludes my summary. I appreciate the opportunity.

[The prepared statement of General Shaud follows:]

PREPARED STATEMENT OF LT. GEN. JOHN A. SHAUD, DEPUTY CHIEF OF STAFF, PERSONNEL, U.S. AIR FORCE

Mr. Chairman, members of the subcommittee. I appreciate the opportunity to appear before you today and state my views on the proposed legislation to change the military nondisability retirement system. I believe there is no element of the military compensation system more vital to the enduring readiness of our armed forces.

Since 1948, when the current retirement system was enacted by Congress, it has provided the cornerstone we need to maintain an effective, combat-ready force to safeguard our national security interests. It has served us during the best of times and the worst of times by giving us the incentive to help attract and retain the right numbers of quality men and women to the service of our country in both war

and peace, during recessions and unprecedented economic growth, in the face of an unstable system of pay and allowances, and through the emergence and success of the all volunteer force.

No other element of the military compensation system is more important to our career personnel. Our studies and surveys consistently reaffirm that the military retirement system is the number one career incentive; and cutting this system is the one thing that would most readily cause the loss of our talented and experienced careerists. Our people view this entitlement as the stable and unifying element in an otherwise volatile compensation system, and as deferred compensation for the many sacrifies we call on them to make.

I am concerned that this cost savings agenda could undermine the morale of our men and women in uniform. They might perceive that Congress no longer values their sacrifices as much, while the sacrifices we ask them to make have not changed. These young Americans who volunteer to serve and make a career commitment ironically give up the very liberties that they are sworn to protect—liberties that other Americans take for granted and their predecessors fought and died for. We ask them to live, fight and, perhaps die, anywhere. We don't pay them overtime for 60- or 70-hour workweeks or being on call 24 hours a day, 7 days a week. They know that during the course of their careers they will often be separated from their families, endure living conditions that we would all consider substandard, and pick up what community roots they've been able to establish and relocate their family with little or no notice. They accept abridgement of freedom of speech, political and organizational activity, and control over living and working conditions.

Certainly, we appreciate the recent positive congressional actions on behalf of the military. I applaud the decision of this Congress to honor our present commitments by grandfathering retired members and those already on active duty from any changes made in the retirement system. I also recognize the recent efforts of this committee to secure a pay raise for military members while congressional and Federal civilian salaries were frozen and to lessen the burden of relocation on our members by recommending improvements in PCS reimbursements. Nevertheless, I am concerned at the detrimental effects that retirement cuts could have on both our present and future force.

Our present force could be affected by the implications of a perceived erosion of support by a deficit—minded Congress. Our future force will be facing a reduction of another 16% on top of the 13% loss due to the high-three averaging in 1980, resulting in over one-fourth less retired pay. After 20 years of military service future members will receive about 25% of regular military compensation, the military equivalent of civilian salary. Current retirees receive about 34%.

No one knows for certain what the retention and readiness impacts of these cuts will be, but I can assure you there will be some. To those who argue that we can always recover from future losses with increased active duty pay or bonuses, I would point out that this policy may not continue to work for us in the future. Despite several years of extraordinarily high retention, back-to-back pay raises of over 25% and generous bonus programs, we are just now recovering from the experience losses of the late 70s. Replacement costs are high and lead times are long. For example, it takes 6 recruits and 13 years to provide a replacement for a senior NCO. We need a year and a half to replace an experienced F-16 pilot who has 1,700 flying hours with a new lieutenant with 275 flying hours and no experience in overseas theaters. It will take seven more years and $1.6M in training before that lieutenant is able to use the full combat potential of that aircraft.

I can't tell you precisely at what point cuts in military retirement would exact an irreparable loss of the career incentive, although I feel strongly there is one. My instancts tell me that this latest cut puts us dangerously close. I am concerned that these proposed cuts will destroy the delicate balance of overall compensation and, by failing to provide the proper mixture of career incentives, eventually result in a lower quality, military force.

To those who would argue that the military retirement system is still better than most private sector pensions, I can only reiterate what has been said many times before. Such comparisons are irrelevant. No job, no occupation, no profession in the private sector can be compared to military service. The purpose of the military retirement system, combat readiness, sets it apart from anything else. It contributes to force management by promoting a young and vigorous force, providing a standing resource of experienced manpower for national mobilization, and building the foundation for a strong system of institutional supports necessary to partially offset the extraordinary conditions of service. In short, it gives our field commanders the right people to carry out their missions—it ensures they aren't forced to use inexperienced airmen or aging NCOs and officers.

You are deliberating what may be the most important legislation affecting the future of our armed forces for many years to come. I urge you to carefully consider the implications of reducing the future of the military retirement system to arbitrary cost reductions. No mathematical model, no survey can tell you what you need to know: what is the most efficient and effective total compensation package for the military? Only observed behavior under a changed system can provide these answers. Unfortunately, the consequences of the wrong formula may be grave and risk the rebuilt quality of our military and national self-confidence. We may not have the perfect system right now, but I firmly believe we're very close. The current system has stood the test of time, through peace and war, and served us well.

Senator WILSON. Thank you very much.

General Cheatham?

STATEMENT OF LT. GEN. E.C. CHEATHAM, JR., U.S. MARINE CORPS, DEPUTY CHIEF OF STAFF FOR MANPOWER

General CHEATHAM. Senator Wilson and members of the subcommittee, thank you for giving me an opportunity to speak today. I am afraid that anything I have to say will be a bit redundant. I will make it as quick as possible.

We support the position taken by Secretary Weinberger on the 15th of November. We do not want to see any change in the present retirement system. We think our retirement system is a sound one based on proven force management principles. It is a system easily understood and one that is working well.

If changes are implemented, we believe there will be a degradation in the quality of the force and a resultant decrease in the readiness of the Marine Corps.

Thank you.

[The prepared statement of General Cheatham follows:]

PREPARED STATEMENT OF LT. GEN. ERNEST C. CHEATHAM, JR., U.S. MARINE CORPS, DEPUTY CHIEF OF STAFF FOR MANPOWER

Mr. Chairman and distinguished members of the subcommittee. Thank you for giving me the opportunity to appear before you today to present the Marine Corps' position on proposed changes to the military retirement system.

Let me state at the outset that we fully endorse the position so clearly and succinctly expressed by the Honorable Caspar Weinberger, the Secretary of Defense, in his 15 November 1985 report to the Congress. While providing the two mandated options for change, the Secretary reaffirmed our steadfast opposition to change.

The existing military retirement system has served the Marine Corps, our sister services, and the Nation long and well. As our primary force management tool, it has provided, and continues to provide, a young and vigorous fighting force which meets our principal goal of personnel readiness. Because the military retirement system serves as a powerful retention incentive, the Marine Corps is able to keep experienced leaders who have reached the necessary level of maturity and have gained the vital experience required to meet technical and, more importantly, leadership responsibilities.

We have today the highest quality and the most combat ready force in the history of the Corps. It is a force composed of educated and patriotic Marines. Our ability to continue to attract and retain the level of quality we now enjoy could be seriously degraded if the retirement system is changed. Analyses of the proposed alternatives derived from the Annualized Cost of Leaving (ACOL) Model tell us that if adopted we could lose, conservatively, 5.4% of our officers and 18.1% of our enlisted Marines from that critical 11-20 years of service component of our career force. Such losses in experienced personnel, especially those for whom so much time, effort, and money have already been expended, would be devastating and present a critical void which would take us years to overcome.

The military retirement system has been the one stabilizing factor in an otherwise erratic military compensation mosaic, and has been a critical and essential element in shaping today's Marine Corps. We strongly believe that changes could ulti-

mately require an increase in other elements of the compensation system to permit us to compete with the private sector for the quality Marines that we require.

In summary, we do not believe that military retirement benefits are lavish or overly generous. Our retirement system is a sound one, based upon proven force management principles. It is a system easily understood and one that is working extremely well. If changes are implemented, we are concerned that there could be a degradation in the quality of the force and a resultant decrease in the readiness of the Marine Corps to meet its national security commitments.

Senator WILSON. Thank you, sir.

Admiral Bell?

STATEMENT OF REAR ADM. HENRY H. BELL, U.S. COAST GUARD, CHIEF, OFFICE OF PERSONNEL

Admiral BELL. Thank you, sir.

Before I read my very short statement, I would like to join my colleagues in expressing my opposition to a change for the reasons they have given. I will continue with my statement.

I am pleased to have the opportunity to testify today on the subject of the military retirement system and the potential impact of changes to that system on the Coast Guard.

The Coast Guard has had the opportunity to examine the two proposals for changing the military retirement system that were provided to the Congress by the Secretary of Defense. It is our opinion that these proposed changes might produce results, the costs of which could outweigh any expected savings resulting from a reduction in long-term retirement expenditures.

In general, the changes proposed might result in a younger, less experienced force, increased accession needs, increased apprentice and specialty training costs, and a significant change in the way the Coast Guard performs its missions. On a larger scale, the proposed reform could impact on national security.

The Coast Guard believes that any consideration of changes to the military retirement system, such as those under consideration, must include an understanding of the impact of those changes on the ability of the Coast Guard to continue to perform its missions. If these proposals become law, it could be necessary for the Coast Guard to make changes in our organizational structure.

Our analysis, based on methodologies similar to those used by DOD and by the Fifth Quadrennial Review of Military Compensation, indicate that the greatest effect on the future force will be on those enlisted people who reach a crossover point about year 12 of military service.

At this point, the pull of retirement takes over from the push of bonus and incentive programs. This pull causes many people who originally reenlisted for a bonus to consider a career. The fact that there is no vesting of retirement benefits prior to the 20th year of service adds to this pull. In effect, anything that decreases the perceived value of retirement decreases the pull to the 20-year point.

This restructuring of our military work force could eventually result in a younger, less experienced force, requiring a greater number of annual accessions. This potential loss of midgrade personnel could also require us to rethink our management philosophy of pushing responsibility and accountability to the lowest organizational level practicable.

More decisions might have to be made at higher levels. Because of the nature of Coast Guard mission, and the tremendous decentralization and geographic distribution of our many small, independent units, the Coast Guard depends very heavily on senior enlisted people to make real-time life-and-death decisions that simply cannot be referred to higher authority.

Because of these possibilities, the changes proposed could have a disproportionately greater negative impact on the Coast Guard, vis-a-vis the DOD services.

In summary, the Coast Guard, with only 38,700 active duty members, is a relatively small armed service. We do not have the resources in place, nor the capability to put resources in place in the short term, to respond to the potential adverse effects of changes as proposed.

The current retirement system constitutes an important form of military compensation. We are concerned about the possible negative impact of these changes on our ability to retain U.S. Coast Guard military personnel.

Thank you, Mr. Chairman. I will be pleased to respond to any questions you or the committee may have about this issue.

Senator WILSON. Thank you very much, Admiral Bell.

Gentlemen, for a number of years now the Department has opposed any change to the military retirement system because the claim was consistently made that the present system was working well.

I am not convinced that that is really the proper focus. It seems to me that we should be asking whether the military retirement system as part of a larger system of compensation and benefits is working in the most effective manner or, to put it more specifically, we should be asking whether we can reallocate funds from retirement into other forms of compensation that seem more directly relevant to today's Army, Navy, Air Force, Marine Corps, and Coast Guard, to retain an appropriately structured force and hopefully save some money in the bargain.

If so, it would seem that the compensation system would be not only more cost effective, but also more effective. So, the question I put to each of you is whether the present military retirement system results in the most efficient use of the $18 billion that is required annually of the taxpayers to fund that system?

I would simply remind you that in 1980 when this subcommittee was considering moving the high three system, the Department was predicting losses in the neighborhood of 40,000 personnel.

I could ask the question: Did we lose 40,000 personnel as a result of that change?

Well, it is a rhetorical question. We all know that we did not. I think we know the reason. The reason was because of other changes that were made, offsetting changes, improvements in the overall compensation system that made the service a more attractive life.

So, I ask you now whether you think what we have is the ultimate or whether you think we might restructure the compensation system, reallocating some of that $18 billion to make the compensation system yet more attractive?

General CHAVARRIE. I think the answer has to be a resounding yes.

When you ask the question, are we utilizing the $18 billion more effectively, the answer is yes. Since 1980 up to the present by almost any measure—whether you measure recruit retention of a career force, retention of first termers, the qualified people that are coming in, number of high school graduates we are taking in—all of the numbers are absolutely the highest we have had in a very long time.

That is a manifestation of using all our personnel effectively. It is, however, subjective. We hate to keep saying that, but how you compensate people is subjective.

Somebody who is 16 or 19 years old is not terribly concerned about retirement. He wants money up front. Therefore, probably pay, benefits, bonuses, et cetera, are more important to him.

The situation is different for someone who is in the force and has committed himself or herself to a career, 12, 13, 14 years. This is the guts of your NCO corps. These are the instructors, this is leadership upon which the NCO corps in all the services is based. These people begin having different responsibilities. It is at that point that somebody decides, "I think it is more important to have money later on than it is in the earlier years." It is a terribly subjective decision to make. What our model attempted to do was to predict the changes in this retention behavior. We said based upon a series of years and the retention behavior in those years, together with certain economic assumptions, inflation rate, real interest, pay scales, et cetera, what does the model predict about the future?

The model predicted the kinds of changes reflected in the report. Of course, if you change the assumptions, you will change the predictions. I think it is a matter, sir, of a person in his early years being more interested in early money, and someone later on interested in later money.

It may be like Senator Glenn probably remembers. In the first 10 or 15 years of flying, we probably would have paid them for flying, we were having so much fun. After a while the responsible part of you comes out and you begin worrying about other things.

This is the subjectiveness of this whole matter.

Senator WILSON. Let me ask you, not just General Chavarrie, but all the members of our distinguished panel, to be more specific.

I really want to know in what specific ways we might reallocate our overall system of compensation, specifically whether some of the money being used for retirement could not be used in different ways.

You have indicated that you think there are different needs at different times and I think that is quite true. I am wondering, I do not know whether or not in preparation for the response required of you under the 1986 authorization bill the individual services came forward with any plans, retirement plans or compensation plans, but, if so, this subcommittee would be very much interested in seeing those.

Did any of the services individually respond with a plan outside the specific requirements of the statute?

Admiral CARLSON. Mr. Chairman, I think you perhaps know that Admiral Watkins, when he appeared before the House Armed Serv-

ices Committee, talked to a plan that was trying to acknowledge the need for reduction, but at the same time recognized the potential loss of all that talent between 11 and 20 years, which is the career force.

He, at that time, had a program—The Individual Career Investment Account—which would be a form of an IRA, in which the Federal Government contributed to each individual member 11 percent of his basic pay each year through 20 years. That keeps him on until 20 years of service and at the end of that time he gets a lump-sum or annual payment.

In terms of a former enlisted man it is about $19,500; for an officer, about $40,000. It is one of those "pay me now or pay me later" plans.

What the man, in essence, does is get some in-pocket money in a lump sum to make a down payment on a home, start a business, or whatever, in exchange for not getting the larger dollars, which are quite significant were he to draw regular retirement pay over time.

That was simply a proposal. It is not without cost. It is not one that would realize $2.9 billion savings; but in answer to your question, it was an alternative proposed and the details of which have some attraction to those we think it would keep in the service. It would demonstrate the concern for the individual. It is not just a face slapping thing that says, "no, we are going to reduce your retirement pay and that is it", it says "we want you to stay longer."

It serves as an inducement to stay longer and you are buying the time between 11 and 20 years.

General CHAVARRIE. The 5th QRMC in its report to you addressed any number of these, and a form of IRA was one of them. We probably have 10 or 20 different options in the 5th QRMC review, and we looked at many different features.

Of course, the 5th QRMC came up short in the opinion of the Department and all the services together. I think that in this case we worked very closely. We were, of course, bounded by the $2.9 billion and the $1.8 to $5.4 billion. There were no specific plans that we did in this review, other than what you saw in the report that the Secretary of Defense sent over, that is, the five limits, $1.8 billion on up, and meeting the $2.9 billion plus your criterion which said one should be structure only and the non-COLA——

Senator WILSON. Under the announced rule, we will have a 10-minute first round. My time has expired.

Let me just say that I personally am very much interested in pursuing the Fifth Quadrennial Review suggestion and I would very much like to see Admiral Watkins' plan.

In my next round, General Chavarrie, why is it the Department feels that those recommendations, those alternatives fall short.

General CHAVARRIE. The QRMC?

Senator WILSON. Yes.

Senator Glenn?

Senator GLENN. Thank you, Mr. Chairman.

In the report of Secretary Weinberger he says that changing the military retirement of new entrants will have "an insidious and immediate effect on the morale of the current forces."

A couple of you addressed this a little bit here. I do not have a good feel for how much that may really come to pass, but changing

the military retirement base from terminal basing pay to the so-called high three in 1980 resulted in a 13-percent reduction in military retired pay.

Is that approximately correct?

General CHAVARRIE. Yes.

Senator GLENN. That changed only for new entrants which is what we are talking about here. Retention of the career force for the last 5 years has been at record high levels.

Why didn't this change to high three then have the same "immediate and insidious effect" on the morale of the current force that the Secretary talked about?

General CHAVARRIE. I think there are a lot of things that are insidious, and we did not mean it in the pejorative sense that you normally think of the word "insidious." We rather take the definition——

Senator WILSON. Insidious is insidious to me.

General CHAVARRIE. Well, sir, there is another definition that says something developed so gradually and becomes well established before it becomes apparent. It was in that sense that we used insidious, not in the sense that we otherwise talk about.

With regard to the 13 percent reduced value of retired pay that occurred when we went to high three, why didn't the retention get worse? Why did it get better? Part of the reason is that it happened in 1980. If we look back over the 5 years to see what has occurred since 1980, with the full support of this committee—VHA, PCS and other entitlements, special and incentive pay—so many good things occurred over the past 5 years, including 11 and 14 percent pay raises and 3 percent pay raises. These improvements suppressed the impact of the high three. Had we kept everything else the same and then analyzed the high three with nothing else changing, we would have seen an impact. It is the combination of everything that masked-out the retired pay changes.

Senator GLENN. I could almost take your words and turn them around and argue for this instead of against it. I have always thought that the modeling done on some of this does not necessarily get into some of the main reasons why people get into it because we saw a big upswing when we had a recession—I will not say depression, but it bordered on that in Ohio. We have had a definite recession for a couple of years, and you did not have any problem at all.

Your recruiters turned people down sometimes because you did not have enough spaces to put them in. That was a major factor. It did not have anything to do with whether we were on the high three or high six, or whatever.

Does your computer modeling factor that in?

General CHAVARRIE. The basic economic assumptions in the model are the interest rates, inflation and the wage rise in the private sector. It does not specifically include an unemployment rate, but it includes those other three factors.

Senator GLENN. Has anybody gone back and looked at what the computer modeling did in 1983 when we were considering high three?

What did it predict was going to happen at the time?

General CHAVARRIE. We are considerably more refined than we were in 1980. Because of that, beginning on January 1 in our office, with the cooperation of the services, we are going to do a study on total compensation to see what the impact is as a result of the things that we have learned and things that have happened since 1980.

Senator GLENN. Let us go to total compensation for a second here. I think offsetting the adverse retention effects of changes in the military retirement system is a very good area to look into also. I am glad you brought it up.

The DOD report on military retirement suggests other compensation changes, increases in reenlistment bonuses, for example, could offset any adverse retention effects of changes to the military retirement system.

When you project the impact of changes to the retirement system on the size of the current forces, what assumptions did you make about reenlistment bonus levels or special or incentive pays?

In the Secretary's report did you make any specific recommendations there that if we go through with a certain change in retirement benefits, that there should be things put up at the front end which you referred to earlier?

General CHAVARRIE. The answer is no, sir, there was nothing in the report that said if you do this, here is what we have to do to compensate for it.

Senator GLENN. I think that is very important. I thought our original instructions to the Secretary requested that, didn't they?

General CHAVARRIE. There is a discussion of it, Senator Glenn.

Senator GLENN. I guess the instructions were if he had to do certain things, what would he do to offset. That is rather general, is it not?

General CHAVARRIE. Yes, sir. Unfortunately, our response is rather general. I think the 5th QRMC analysis has a lot of analysis in it with respect to that, but the answer to your question is no, we did not say if you do this, here is what we would need to do in specific terms to compensate for that.

Senator GLENN. This all ties in to what Admiral Carlson said a few minutes ago about the overall career compensation. The fellow starts out in the military, he is going to have a career, does he come out at the end $100,000 short?

Admiral CARLSON. Yes, sir.

Senator GLENN. Say that again, what you said.

Admiral CARLSON. If one of those two options were to be enacted, the member participating in that would over a life stream earnings measurement receive in total compensation $100,000 less than someone who would retire today on the final pay system.

Senator GLENN. On the specific recommendations that if we enact certain changes in retirement pay, what offsetting bonuses or enticements could be given at some other stage in the career?

I would be interested in hearing your comments on that because I do not want to see us just say, "We are going to cut you here" and not make a compensation someplace else, that we will gradually whittle some people down, which is your concern on the current force.

I did not agree with you on part of your statement where you said they are going to walk with their feet. That is the current force you are talking about, not recruits coming in. This does not apply to current force.

Admiral CARLSON. I meant that to apply to those getting out beyond the second enlistment under one of these new options. We believe they will not stay.

Senator GLENN. They are locked in, though. You are talking about in the new program 15 years down the road?

Admiral CARLSON. Yes, sir, 10 or 12 years. That is why it is so hard to measure. We think it is going to result in a negative impact because it is quite a change from the guy who joins a month before and is under the high three system. He is going to end up earning more money during his lifetime than one of the individuals who signed up if one of the two options is enacted.

Senator GLENN. Would any one of you want to comment on what compensation would be put in if we chop back on retirement benefits?

Is it going to be required that we put in a reenlistment bonus up front, lump-sum payment, whatever?

Admiral CARLSON. Admiral Watkins thinks the Individual Career Investment Account does it. In essence, you are giving the man a 1-year reenlistment bonus as he goes along that he cannot receive until he gets to 20 years of service. When he gets to 20 and says, "Where are my bucks?" then we say "Here is your 20 grand." It costs us some money.

It does not achieve the $2.9 billion reduction which was mandated, but it seems to us that it is a way to maintain and attract the career guy between those critical years.

Senator GLENN. The deferred compensation idea is one that back in years past, when I was in, we always looked at. We were not doing very hot on the month-in and month-out pay. We were doing poorly compared to our compatriots on the outside, but you had a pretty good retirement system. That was like deferred compensation to us.

Admiral CARLSON. This way we are going to give you a big bag of bucks. The guy says, "Hey, I will stay for that."

Senator GLENN. You had a deferred compensation idea that was very attractive. Nowadays the pay has gone up considerably. It is comparable to civilian pay. It is pretty good. That is the reason there is a little push to cut back a little on the retirement system that we used to look at as deferred compensation.

Does anyone else have any ideas on offsetting benefits?

General ELTON. The work done by General Sherman in the QRMC really was a landmark piece of work.

Senator GLENN. I am sorry. Say that again.

General ELTON. The work done by General Sherman and the people on the 5th QRMC last year was a landmark piece of work because they marched in with the idea that we wanted to maintain the readiness of the force.

When they left, they left with the idea that we believe, and we can argue with the models all day long, but they walked out with the idea that we believe that the readiness of the force will be maintained if we do the following things.

In other words, an offsetting change to compensate for losses in the retirement program. Their recommendation was an up front bonus similar to the one that the Navy is suggesting.

Senator GLENN. At what point now? When would the bonus come in?

General ELTON. The bonus would come in at the 20-year point. It was larger than the one recommended by the Navy. The point was that it was an offsetting money up front deferred, if you will, for the fact that they were going to be losing life stream earnings in retirement.

There were other ways in which modeling tells us it can be compensated and the force can be restored. All of us believe in keeping the force combat ready. Everything else pales in significance to that particular requirement.

How do we do that? That is one way. There is another way, of course, we think could possibly help and that is additional reenlistment bonuses.

As the Army looked at that, in our particular case, since we have some 280,000 noncommissioned officers that might be interested in this at one time or another, that jumped to about 154 million above what we already requested and that is a tremendous amount of money just to restore a smaller portion of that particular force.

Senator GLENN. Do you have figures that show if you had to do all that bonus business in here to keep people in and cut the retirement pay out here, what you actually save in the long haul?

Do you have anything that shows whether you are really saving money long haul or not?

We taketh it away on the one hand and giveth it on another and we wind up with the same sum total at the end. So, you might as well not change if that is what the effect is going to be.

General ELTON. What we do not know is whether they will work completely. In some cases there is a possible offsetting savings. We are really not sure that that, in fact, will cause the force to be retained completely, whereas we think this system with the retirement system as it is now, with the reenlistment bonuses we have now, and so forth, does actually enable us to do that.

Senator WILSON. Senator Exon?

Senator EXON. Thank you, Mr. Chairman.

Gentlemen, this is a very complex issue that we have been wrestling with for a long time. Let me ask you this question.

Twenty years has been the basic retirement point in the military for a long, long time.

Was it that way from the beginning and when was the beginning? Does anybody know? Why 20 years? Why not 18 years or 12 years or 28 years?

General CHEATHAM. I do not know exactly when the 20-year retirement was introduced. I can remember my father telling me that after World War I they were releasing people with varying lengths of active service: 16 years, 12 years, et cetera. I am assuming that the 20-year retirement came along sometime after World War II.

General CHAVARRIE. I think the experts say World War II.

General SHAUD. I believe it was 1947 when the concern was to preserve a very vigorous force. If anybody stays 30 years and

longer, there is stagnation at the end of the career, it blocks motion and has a lot to do with energetic and ambitious people you want to bring along leaving the service.

Admiral CARLSON. There is a basis in law. I believe officers by law may serve 40 or more years unless excused by the President or the Secretary of the Navy. Enlisted personnel serve for 30 years minimum. When he retires at 20, he goes to the Fleet Reserve in the Navy. So, he is available and he recognizes that. His name stays on the roll for recall in time of national emergency.

Senator EXON. Is there an average today—averages do not mean anything in and of themselves—but is there an average today of enlisted men and officers?

Admiral CARLSON. In terms of service?

Senator EXON. In terms of service before they retire?

Admiral CARLSON. Yes, sir; in the Navy the average enlisted man has 23 years of service when he retires and the average officer has 24 years of service when he retires.

Senator EXON. Almost the same; is that right?

Admiral CARLSON. They are about the same.

Senator EXON. Is that true in the other branches?

General ELTON. That is true in the Army.

General SHAUD. And in the Air Force.

Senator EXON. Why is that?

All of you are having the same people retire at the same age. It has to be something to do with the retirement system that is common to all the services.

Since I do not see a great deal of divergence of opinion among the witnesses, and to a large extent, I do agree with them. To a large extent I have supported the existing system because I think when we make a commitment to someone, we have to live up to it.

Nonetheless, I am puzzled to know why we have a 23-year average service. That means a person going into the service at 18 or 19 is out when they are slightly over 40 years old, roughly.

General CHEATHAM. I think that is one of the keys right there. If you have an 18- to 22-year-old man going into the service and he decides to change careers after 20–23 years, he is around 43 or 44, an age which I would say he would be considered in the business community as a hireable product. He is getting out on the border.

If he get out at 48, he has passed that hiring time. So, these people think about that. It is my personal opinion that this is one of the major factors.

Admiral CARLSON. Also, we have closely structured our system, as has been pointed out. The youngster who comes in does not care about retirement in his first term. When it comes time for the second term, however, he says, "Yes, I like what I am doing, the money is good, I am having a good time." So he ships over again.

We give him dollars to do this. As he becomes more senior and more skilled, we give him more dollars to ship over. By this time he probably has a wife and he is down to 11 or 12 years. You can say, "If you look at 20, you can see the light at the end of the tunnel, but we want you to get onboard ship and go to sea again."

You know, in the Navy it is like Samuel Johnson said, "Going to sea on a ship is sort of like being in jail with an opportunity to drown." So, at the end of 20 years the guy says, "I've had enough

of this. I want to go to Nebraska and raise cattle. I am tired of the ocean."

Senator EXON. He will not do that any more. Those are the days of yesteryears. Let me ask you another question.

Does this average 23 years in the service also apply to categories such as an aircraft crew chief or pilot?

Correct me if I am wrong. We do not want all our fighter pilots to be in their forties and fifties, but a crew chief could be. What is the average retirement age of fighter pilots today?

General CHEATHAM. I think if the average is 23 years of service as an enlisted marine he is usually a gunnery sergeant. If it is 24 years as an officer, he is usually a lieutenant colonel.

Senator EXON. The "up or out" promotion requirement also puts some pressure on retirement age, as well, I suspect?

General CHEATHAM. Yes, sir.

Senator EXON. Is that good?

General CHEATHAM. Yes, sir. The up or out.

Senator EXON. Yes, sir.

General CHAVARRIE. This is what keeps everybody young and vigorous. That is what keeps the pressure on people to continue to excel because you are competitive from the time you come in. If you lose this kind of competitiveness, this moving up the ladder, I think you lose a lot of military.

Senator EXON. Getting back to the situation of a pilot again. Certainly fighter pilots do not stick around until they are 43 years old, do they?

General CHAVARRIE. Yes, sir.

General CHEATHAM. There are fighter pilots now that are colonels and brigadier generals, 44 years old and in senior command positions. They still call themselves fighter pilots.

Senator EXON. Am I wrong in my belief that after they get beyond 30, they are not up to snuff as far as a good fighter pilot is concerned?

General SHAUD. Some go on to command opportunity. An average officer in O–5 will just about have his opportunity for squadron command and, like you mentioned, it begins to net down and at that point he is past retirement and he observes his opportunity to progress to wing command, and so forth.

It just becomes the opportune time to leave for pilots as well as the rest of the force.

General ELTON. One thing I would like to mention, not about pilots, but about the syndrome after 24 years of service, generally most of them are colonels by then. You have to figure out that that is a very select community. If they look around them and find after 24 years of service that they perceive that there is no more further upward mobility, these are competitive guys and they want by golly, to keep moving.

So, many of them look for daylight and try to go into something where they can be productive. It is a time when their families are growing and moving into college, many of them, and they absolutely do not want to tail off and they look around and that is just the fact of being in a very highly competitive arena.

Senator EXON. Maybe I am wrong. I can understand that you do not want fighter pilots much over 30 years of age.

Senator GLENN. That is not true. I am not making a joke out of this. I was not atypical when I was in Gemini. I was doing my best test work at Patuxent River when I was in my upper thirties.

I was beyond 40 when I was in the astronaut program and made an orbit of the Earth. I was not atypical of my colleagues at that time. We had a lot of folks that were senior operations officers, executives of squadrons or squadron commanders out there leading the younger guys you are talking about and doing a heck of a job.

I think you are scaling down 8 to 10 years from what the actual situation is out there, the guys who are really topnotch fighter pilots. You need the experience, too. You do not just throw the guy into the cockpit because he is young and vigorous and thinks he is a hotshot fighter pilot. It takes years of experience before he gets good at it.

Senator EXON. Let me get around to the question I want to ask. I am concerned about the fact that the retirement system that we have today encourages a topnotch crew chief to get out of the service when he reaches 20 years of service but may still be of value to the service.

I can see why it may not be prudent to retain some pilots beyond 20 years service. It looks to me as if the retirement system should be more flexible and deal more realistically with the different requirements for each military specialty.

I agree with you, Senator Glenn. I like experienced people, whether they are pilots or other. I suspect a pilot might like to have a 53-year-old crew chief working on his aircraft rather than a 23-year-old kid that just came out of school.

Senator GLENN. I agree with you.

Senator EXON. Maybe we should have a retirement system that keeps people in certain categories such as maintenance or logistics in longer than fighter pilots or combat troops.

I think we are putting too many people out of the service with our present system after we have invested an awful lot of money on them. I think maybe some restructuring is in order to see if we cannot have more career people in the service who will stay in the service until they are 55 or 60 years old, not flying around up there or being fighter pilots, but doing things that 55- or 60-year-old people can do almost as good as a 25-year-old youngster.

That is one of the concerns I have about the system we have today.

Are you telling me that you do not think by some restructuring we cannot make better use of people by changing not only their compensation, but their retirement to keep them in longer rather than 23 or 24 years?

If the people are as good as you say they are, and I think they are, and if I were running a business, I would not want only people who were only 23 or 24 years; I would want them in my business 25 or 40 years. I am not sure they can go out and carry a big gun up the hill and all those kinds of things but many military skills do not require that.

We should be looking to see if we cannot come up with some innovative ideas to make better use of men and women after we get them trained.

My time is up. Thank you, Mr. Chairman.

Senator WILSON. Thank you, Senator Exon.

Let us come back to the point that we had left and that is what options may exist beyond simply responding. I understand that we require a specific response. I am not in the effort to try to achieve what I earlier described as a reallocation of resources to make the overall compensation system more effective. I want to pursue some of the specifics.

I gather, General Chavarrie, what you are saying is that there are a number of attractive options that are cited in the Fifth Quadrennial Review and several of you have made favorable reference to that. One, though, was, to come back to the point from which we departed, a system somewhat akin to an IRA. There were a number of those addressed in the Fifth Quadrennial Review.

Your statement was that the Department found those lacking, that they feel short. Why so?

General CHAVARRIE. Sir, if I could answer first. It seems to me that the military services are unique enough, in terms of risk, potential hazard, and possible death, that a military retirement system which recognizes this uniqueness is not an inordinate thing. That is, should someone who sacrifices what a military man and woman sacrifices for their country, should they have part of their earned income become transferred to part of their income maintenance or income supplement in their old age?

What we are doing is mixing the public sector and the uniqueness of the military service. We, as the Secretary of Defense said, do not think the amount of money that is being paid in retirement is inordinate to pay for continued compensation for somebody who spent 20 or 25 or 30 years in the active service of his country and remaining subject to active duty recall, if needed.

To make that kind of system hook up with an IRA, which makes very good sense in the private sector, is an income transfer that we do not need to ask a person to do because of military service.

I know that in Civil Service they are talking about some kind of IRA. In the military service, however, I believe that service is unique enough so that it is not an inordinate amount of money to pay people for the unique service they perform without having used part of their earned salary and transfer it to retired pay.

Senator WILSON. If that is the criticism on that account, then come back to the Fifth Quadrennial Review noncontributory, early withdrawal program, the very options that were provided there.

I take it you agree with the conclusion stated there that:

> The current retirement structure can be restructured and strengthened to produce the same or improved force profiles as the current system and thus sustain mission readiness at less cost.

If you agree, I wish you would say so. If you disagree, say so.

General CHAVARRIE. Is that a quote from the 5th QRMC?

Senator WILSON. Yes.

General CHAVARRIE. The Secretary of Defense did not recommend any options in the 5th QRMC. He sent the study over to the Congress as a report and analysis. We did not take a view on any of the options on the 5th QRMC.

Senator WILSON. Let me ask you to do that now with regard to that statement.

The current retirement structure can be restructured and strengthened to produce the same or improved force profiles as the current system and thus sustain mission readiness at less cost.

Do you agree or disagree, and why?

General CHAVARRIE. I disagree with the conclusion that if you say yes to it, that that would mean fine, let us do it. Let me say what I disagree with and what I agree with on that.

I think the 5th QRMC did the study and analysis and said we need a big wad of money up front to make up losses. The 5th QRMC said we have 2.1 million men in the Armed Forces. We think that is a pretty good force. We think that is the way it is going to be in the future.

What does it take to retain that same force? There are a lot of assumptions in the QRMC. All these factors went into it. They said if we reduce retirement this much, we have to do something here. If we reduce it less, we have to do it less here. It is an econometric kind of model. It said whatever you take out, you have to put back in and that keeps the force level. That is the essence of the analysis and it is adaptable to various scenarios.

One of the things that made the 5th QRMC option not particularly attractive and one of the reasons that there was no recommendation made by the Department of Defense on the QRMC was that the up front money, the lump sum was vulnerable. In some cases was, as I recall, it was 3 or 4 years base pay at the end of 20 years, whether you stayed in the service or not. Now, I am not sure that the Congress would think that would be good. If a lieutenant colonel arrives at the end of 20 years and gets 3 or 4 years worth of base pay in a lump sum, something over $150,000 whether he stays in or not, I am not sure that would be considered terribly attractive in the era of deficits and money cuts.

That is one of the factors that we took into account when we did not make any recommendations on 5th QRMC. It is an awful big lump sum, and we are not really sure when the time came to pay it off that it would really be viable.

For enlisted members the viability of a lump sum was the same. I think it was 4 years base pay for enlisted members. That is a big wad of money.

Senator WILSON. It is a big wad, although I think under the particular option you have chosen for illustration, if I am not mistaken, the savings were estimated to be about $2 billion even if they took the money and ran and did not stay.

General CHAVARRIE. They were near-term savings, but if you look at it over a long period, and understand the money is still to be paid. It depends on the timing of the payments. If you pay it later and count inflation, it could be paid in more dollars if you wait for 20 years. For example, 20 years worth of inflation and pay raises.

The 5th QRMC is a very good analysis document. It is very tough, however, to hang everything on it. That was what we found very difficult to do. It is not the be-all and end-all for analysis. You cannot say let us do it, let us go for the lump sum—that is going to take care of everything. It was the opinion of all the services and the Secretary of Defense that the 5th QRMC, although it was a great analysis, was not the solution to doing something about

changing the military retirement system. We took much the same view that was in the report, that is, the system seems to be working all right. To everybody's measurement, it says it is better than in the past. So, there seems to be a reluctance to change what we think is pretty good.

General ELTON. I might add one reason that there was not much discussion in the response to the Congress from the Secretary of Defense is that we got a bogey and they come back with a——

Senator WILSON. I understand that. The question now goes beyond the instruction. I understand that you did have a bogey and you are responding specifically to that.

What I am asking for is a response to the contention in the Fifth Quadrennial Review that there can be restructuring that can make the system more effective and more cost effective.

General CHAVARRIE. Sir, we plan to do it. We will begin in January. We are a lot smarter than we were 5 years ago in modeling and analysis. We will look at the total compensation system, pay, benefits bonuses, quality of life items, PCS initiatives—the whole package, including retirement—for the kind of things that we ought to do if you slash any of those. We are going to take that on and say if we reduce the retirement by *x* percent, what do we have to do in order to retain the retention and recruiting we have now. Are we going to have to increase the selective reenlistment bonuses? Are we going to have to give more enlistment bonuses? Starting January 1, we are going to start doing that.

General CHEATHAM. I think one of the things we have to remember is that this is not just old age retirement. It is also a force management tool Decisions that we make in regard to enlistments, reenlistment bonuses, extensions, and particularly changes to retirement will determine the size and age of our force in the future.

As the Senator mentioned, we have to have good specialists who are of a technical nature whom we would love to keep until they are 45 or 50 years old. On the other hand, we have to keep the 19-, 20- and 21-year olds, as they make up a great portion of our combat units. It is really important that we remember, whatever we do, that we have to keep retirement as a force management tool.

Senator WILSON. Thank you.

Senator Glenn?

Senator GLENN. Do you think we should go to the draft?

General CHAVARRIE. No, sir.

Senator GLENN. How about the rest of you?

General CHEATHAM. We are doing so well right now, I would not want to see it.

Senator GLENN. I do not want to see it either. I am thinking in terms of $2.9 billion. Maybe there are savings in starting with a required service of some kind. Some studies have shown we come out neutral by the time we train people and turn them over fast on a 2-year hitch.

General CHAVARRIE. We did a cursory look at that some time ago. I think there is a myth about the draft being less expensive. It is not. It is more expensive. What we have to do with the training base is to bring about 2 or more million youngsters in every year, I think we have estimated, and I wish I could remember these num-

bers, but it is in the billions of dollars needed to increase the training base to simply accommodate the people.

Senator GLENN. You are talking about training everybody, not having a draft lottery type thing that picks out the numbers you need?

General CHAVARRIE. I am talking about a draft that is not just 200,000.

Senator GLENN. I am talking about when you are 18, your time comes up and if you need that person, you get him and that is that.

I am not talking about universal military training for every single person.

General CHAVARRIE. I think if it were a fair and equitable draft, that certainly would be a consideration. The question that is always asked rhetorically is: Who serves when all do not serve? We say that the All Volunteer Force is working well and we have the highest state of readiness. Everything is good and why change it?

Senator GLENN. Did your modeling take into account whether we should consider Social Security or not?

There is currently no integration of Social Security benefits and military retirement benefits. Military retirees receive their full Social Security benefits without adjustment to their military retirement benefits.

It is my understanding seven of the last nine major reviews of the military retirement system recommended that DOD should seek legislation to integrate military retirement with the Social Security system.

What is the Defense Department's position on integrating military retirement with Social Security?

That would be big bucks we are talking about.

General CHAVARRIE. I do not know which studies recommended that. I have not been around that many years. I cannot recall a Department of Defense study that recommended, I am sure there was, and someone can find one, but I think we are already partially under Social Security because the military has paid Social Security, as you know, since 1957.

Senator GLENN. I do not think it has been integrated into our consideration of retirement benefits, has it?

General CHAVARRIE. It has not.

Senator GLENN. Was that in your modeling?

General CHAVARRIE. No, sir, it was not. We have not considered Social Security as part of the military retirement system.

Senator GLENN. It is coming out of your military pay while you are in.

Should that not be considered when you are considering what a person will get for lifetime compensation on coming out?

General CHAVARRIE. It is coming out on base pay. I suppose you could say we are partially under Social Security.

Senator GLENN. As I recall the figure now, and correct me if I am wrong, I think the average person now getting Social Security benefits gets roughly three times what they pay in. In effect, you are getting a multiplier on Social Security like everybody else does and that is part of your overall military package.

General CHAVARRIE. Not everybody that collects Social Security has to join the military and serve. The military pays Social Securi-

ty. So does every other American. It seems to me that by virtue of your paying into Social Security, you are entitled to something as an American citizen. Everybody is.

As a separate matter, you have the service that you perform as a military member and the entitlements earned from that service.

Senator GLENN. When are we going to do some smarter modeling—that is a sort of buzz word with us—doing smarter modeling now than we were when the last studies were run last year?

General CHAVARRIE. The QRMC began about January 1983.

Senator GLENN. We talked about the modeling done back in 1980. I am sure we have learned something over the past 5 years about it.

How are we going to do smarter modeling than we have finished right now?

General CHAVARRIE. I do not think you can ever get smarter in modeling. I think you can get more sophisticated with the input you use. You can put a data base in for a longer period, perhaps, than we did before. There are a lot of things you can do, but they are merely assumptions. All you have to do is put stuff into it. I think it is the sophistication and credibility of the input that is important. I think we are better at that.

Senator GLENN. The combination options which some people are supporting to save the $2.9 billion includes a proposal to change the current annual full CPI COLA to a COLA of CPI minus 1 percentage for life with a one-time restoral at the 40th anniversary of the entry into the service.

Did that come off the top of somebody's head or was that picked for some specific reason?

That sort of lost me a bit there. Why did we make the restoral at the 40th anniversary? Would it not be easier to understand if you made it the same for everyone?

Why the 40th anniversary of entry into the service even though you may have been retired many years at that time?

General CHAVARRIE. I think the answer is for equity purposes. Let us say an enlisted man, the average enlisted man retires at a younger age and at less money, of course. An officer retires at an older age and more money. Assume that the enlisted man retires at 40 and an officer at 55, the enlisted man would at the end, if you go to age 62 and he retires at 40, he is going to have 22 years before he gets to that stage where it is recomputed in the combination option. An officer would have a shorter time because he retires at a later time, so it would not be as long.

For an enlisted man from the lower age until 62 would be a very long time. If you say 40 years from the time that they enter, it is an equalizer so that there is no unfairness to the enlisted member who retires at a younger age and at a lesser amount of money.

Senator GLENN. Senator Exon was discussing 20-year retirement which concerns a lot of people. They say that is a sort of freebee here.

I think your point was well taken a while ago, whoever made it, who said that is the only way we keep a lot of people in until 20 really. I think that is true.

I think that is a carrot, in fact, I thought your portrayal of what you do at different stages in a young fellow's career to keep him in

the enlisted rank, the final carrot that keeps him beyond 11 or 12 years is, "You tell him, you only have 7 or 8 more years, why not put in 7 or 8 more years and that puts you out at 20."

Otherwise, they will be gone, at 10 or 12 years, for sure, a lot of them. I am turning it around and arguing the other side of this thing.

How does this affect Reserve retirement?

We are depending more on Reserves than we have in the past. What is this going to do to the Reserve forces.

General CHAVARRIE. I think what the draft legislation will do is treat the Reserves in much the same way as we treat the Active Forces. There will be an equity between the two.

As you know, when a reservist retires from active duty, he does not collect any retired pay until age 60. So, I think that the legislation says that right now, let us say, you retire at 50, at age 60 you go and get your money. As a reservist, you get paid at the base pay of—say you are a colonel—you get paid at the base pay of a colonel when you arrive at age 60. That would include all the increases that have been included for colonel, even though you have not served on active duty. It is kind of a COLA you have gotten because the pay raises over the years that you have not been on active duty will be reflected in your pay. In this case it will not be that way.

We think that when a reservist retires at age 50, he goes up at age 60 to get his retired pay, it should be the base pay of when he entered retirement. To make up for the loss, there will be a cost-of-living adjustment for that reservist over that period when he was not on active duty. It is a complicated formula because they go off active duty and come on for their 2- or 3-week period. For that service, they accumulate retirement points.

I think I can assure you, sir, that in the final analysis there is equity between Reserve and the Active Forces.

Senator GLENN. My time is up, Mr. Chairman. Thank you.

Senator WILSON. General Chavarrie, there are several components to the existing military retirement system, the noncontributory system on which you have already expressed the Department's view, the 20-year vesting, the maximum vesting, 30 years of service, the percentage multiplier, the retired pay, pay derived from basic pay which is based on retirement grade raise in service, lifetime payout schedule and cost of living adjustments mechanism.

With the exception of the COLA mechanism, each of these has been part of the military retirement system since 1948 and some go back even earlier than that.

In the proposals that have been submitted by the Department, each of these features is retained.

How important is each of these individual features to a military retirement system? For example, how important is retention of the 20-year vesting feature or the lifetime payout mechanism?

General CHAVARRIE. I am sure my colleagues can comment on this as well. If you ask me what priority is the most important one, I would say the 20-year retirement is the most important.

It is tough to give you any factual data to say that is absolutely the most important thing. I think it turns out at the age and the way people operate. The 20-year requirement has come to be some-

thing which the forces, both enlisted and officer, have come to rely on as a given. We did not want to do anything drastic, we did not want to change when we were doing this latest analysis in our report to you. We wanted to keep as much continuity as we could.

I think the consensus was, in the Department, that the 20-year retirement was a given. So that I would put that as my No. 1 priority. I think it keeps a young and vigorous force, among other things.

I think that lifetime earnings which pick up the COLA in the out years, are very important. I probably put that as No. 2.

I think the 75 percent at 30 years, as it is intended to draw people from 20 to 30 would be of third priority.

I think a COLA is perhaps, my personal opinion, a No. 4 given. The reason, of course, is that we do want to pay attention, and I use "insidious" in the sense I defined it, I think there is an insidious nature to inflation. I think COLA is very important. When our men and women become 70, 72 and up, I think it is absolutely necessary that we do not let inflation erode their lifetime earnings.

In the main, I think those would be the way I would prioritize them. I am sure people have other ways, sir.

Senator WILSON. When you indicated you thought the second priority was the lifetime earnings, you are contrasting that with the 5th Quadrennial suggested alternatives for lump-sum withdrawal?

General CHAVARRIE. Yes, sir, you could say that.

Senator WILSON. Does anybody wish to express different views or suggest different priorities?

General ELTON. I guess, to add to what he has said, back months ago when we were getting together our best thoughts on how the service should come down and what issues we could agree on, we discussed these various items and the 20-year retirement option was the key issue that all the services were able to agree on as their top priority.

The others, as he has mentioned, are right up among them, we can put them in any order, but they are also very important. The 20-year one was the most important.

Senator WILSON. General Chavarrie, you said that Secretary Weinberger had indicated—I guess more than indicated, had directed—that you undertake immediately after the first of the year an examination into how you will keep force readiness if confronted with the projected cuts in retirement.

Did I understand that?

General CHAVARRIE. That would be a part of it. What we want to do is look at the total compensation package to include retirement pay benefits in the whole scheme of things and say what is really important.

The reason that we are going to do that—he asked us to do it—is for the same reason I am sure that is going through your mind. If we are going to do something about retirement, what, if anything, do we have to do to the other things and in what degree?

Senator WILSON. Since you and I both share concern about the problem that we face of being in deficit on this, what is the time frame of that examination?

General CHAVARRIE. We have not thought about a time frame. I guess we can do anything in whatever time frame if we put the re-

sources to it, short of 3 weeks. It would take a little doing, but, as I say, I do not want to say it is going to take a year to do because that is crazy. It could be the greatest study in town, but it would be totally irrelevant.

I would say in a reasonable length of time. What we are intending to do is look at it as a package to try to see if we cannot get some other insights because it is a never ending problem with the full knowledge that there is not going to be anything we are going to put in concrete even at the end of that.

That is what we are charged to do.

Senator WILSON. Well, unhappily, and I think this is a point that deserves emphasis, unhappily, through no fault of yours and I would frankly say through no fault of this committee, not only the subcommittee, but the committee, we find ourselves very late in the season facing a very unpleasant set of exigencies.

I am very much concerned about that, as you are, as you made clear in both your written and oral testimony, and I am concerned about something else that we have not discussed and that is the very real possibility, in fact, I suspect the probability, that Members of the Senate and I am sure of the House who have not given the kind of time and attention to the complexity of this compensation problem may raise floor amendments as early as the continuing resolution.

I think it is known to everybody in the room that we are not going to consider on the floor the Defense appropriations measure as we ordinarily do, that it is to be melded into the continuing resolution.

I anticipate—I hope I am mistaken, I would love to be wrong—I anticipate that there will be amendments offered to the Defense appropriations portion of the continuing resolution, probably across the broad spectrum of its coverage having to do with weapons, systems, and having to do with manpower and personnel matters, and I suspect specifically having to do with retirement. That is no small part of my concern about the urgency of this committee's acting.

What I am imploring you to do in defense of the best system that we can come up with under this time pressure that you have not created and we have only partially created, is to really work with the committee so that we can fashion a response that will not only be the right answer, but also a response that will allow you to resist well meant, but misguided efforts to amend the continuing resolution on the floor where it will undermine a really realistic and responsive answer.

In that connection, are there features in either of the two Departmental proposals which any of you believe will have a more unfavorable effect upon your service's ability to manage the force than would be the case generally?

General ELTON. With regard to the Army, sir, the effect of combination proposals, vice the high five, has a lesser undesirable impact than does the high five. We have modeled it, reviewed the ACOL modeling and we have your model that we worked in conjunction with the Defense Department.

We have found in every case in every year which is shown in those charts we have a greater impact with the high five.

Senator WILSON. General Cheatham?

General CHEATHAM. You would consider it has a negative impact above the high five.

Is that what you are saying?

General ELTON. Yes.

General CHEATHAM. We support it. The least damaging is the combination.

Senator WILSON. Any other response?

Let us assume notwithstanding the Department's and each of the service's stated position that there is a change made, that Congress nonetheless elects to alter the retirement system in one of the two manners proposed, if those are the only two options, which option would each of you recommend to this subcommittee, and could you briefly state why you prefer one choice to the other?

General CHAVARRIE. Let me begin, sir.

I think if you were to ask me, I would say that I would like to have a third choice and that is to stay as we are.

Senator WILSON. That is clear.

General CHAVARRIE. That is clear.

Senator WILSON. That was not the question, however.

General CHAVARRIE. That was not the question, no, sir.

I think if you compare the two options, the combination option and the structure-only option, we have all done this analysis and we have done it together.

The combination option is the least damaging of the two. There is still a little subjectivity in that, and that has to do with do you want your money up front, or do you want it later?

Everything considered, the way the analysis was done, we believe there is less damage in the combination option, less damage in terms of the impact on the readiness of the force retention, et cetera.

Senator WILSON. From that statement, and from the silence, I take it that there is concurrence?

Is there a dissenting opinion?

Admiral CARLSON. Sir, to ask which one we like is, to the Navy's view, sort of asking which eye would you like to have poked out? We do not want any eyes poked out. If you aim and shoot with your right eye, I guess you would rather not have the right eye poked out, so poke out the left eye.

We would not like to have the Navy's name as favoring either one of those two. We do not favor any one of them. We are opposed to both of them.

Senator WILSON. Admiral Carlson, it is clear, and now I am not being in the least facetious, that the status quo is the preference.

Admiral CARLSON. Yes, sir.

Senator WILSON. But I am asking you to be realistic and bear in mind what I just said a moment ago, there are worst alternatives yet in mind. As you are aware, the $2.9 billion figure was a compromise.

Admiral CARLSON. There are less total life stream earnings lost in the combination option than there are in the structure-only. So, you lose less. You still lose a lot, but lose less with that one.

Senator WILSON. This is my point, but, nonetheless, I think perhaps since this comparison has been made, it would be useful to clarify it for the record.

General Chavarrie, in your written statement you comment, and I have heard this a number of times, that 64 percent of our enlisted retirees draw annuities below the poverty line for a family of four.

How much of that 64 percent actually are supporting a family of four when they go on retirement and for how many years afterward do they continue to do so?

General CHAVARRIE. That is a question that we really cannot answer. We can get back to the building and see if we can find it.

That is a statistic, nevertheless, that exists. It is a fact that that number of families are now—if we say to ourselves, yes, but that number of families, even though they are getting a retirement pay at the poverty level, that is not their total income. So, there are a lot of followon questions to that.

We can do it very quickly, try to find the answer to that if we can, shredded out a little bit, but certainly we cannot follow from that and say 64 percent of the people are living in that situation because they may have other income.

General ELTON. I was looking up our figures. We have 48 percent of our current retirees drawing annuities.

Senator WILSON. I could not hear the last part.

General ELTON. Forty-eight percent of our current retirees draw annuities below the poverty level for a family of four.

Senator WILSON. I am not nitpicking at all. I am curious about that statistic, both because clearly in some cases if you have the retiring gunnery sergeant and he is a bachelor, then he is not in bad shape.

If we are talking about someone who is supporting a family of four, you have a totally different matter. If you could break that out, I think it would be useful to do so.

General CHAVARRIE. All right, sir.

[The information follows:]

POVERTY LEVEL/FAMILY SIZE FOUR

It is an accepted fact that for normal usage in reference to the poverty level, "family size-4" is the standard. This represents the wage earner, a spouse, and two children—a typical example of a family unit in the working population. The poverty level for a family size-4 is $10,610 per annum.

Comparing that poverty level to amounts of retired pay for members, we find that about 48% (506,000) of the retired population falls below that standard (enlisted members=64%/495,000; officers=4%/10,000). If a lesser standard were applied for the military, such as family size-3, we find that about 19% are below that poverty standard (25% enlisted member, 0.7% officer).

The following information was extracted from the DEERS Data Base on the retired population. About 221,000 members have a family size of 4+ (member plus 3 or more dependents) from a total population of 1.215 million retirees (excluding survivors and temporary disableds), or about 18% of retired members, actually have a family size of 4+. Of the 221,000 population with a family size of 4+, 179,397 are enlisted members and 41,833 are officers.

On this subject, another statistic is relevant—that of age. Of the total retired population, 814,364 are under age 60 (141,922 officers and 672,441 enlisted members) and could be assumed to be still in a family mode. Consequently, the bulk of our retired population still falls within the wage earner population against which the family size-4 is applied in the general population. Since military members are retired at what is the mid-point of a civilian career, the family size-4 standard continues to be an appropriate standard.

Senator WILSON. Admiral Carlson, lest I was not clear earlier, I would like to see the work that Admiral Watkins has done.

Admiral CARLSON. We will submit that for the record.

Senator WILSON. And not just the recommendations if it is in draft legislation form. I would like to see the actual analysis.

Admiral CARLSON. Yes, sir; we will get that over to you.

[The information follows:]

DEPARTMENT OF THE NAVY
OFFICE OF THE CHIEF OF NAVAL OPERATIONS
WASHINGTON DC 20350 2000

~~OP15-B5~~

IN REPLY REFER TO

05 DEC 1985

The Honorable Pete Wilson
Chairman, Manpower and Personnel Subcommittee
Committee on Armed Services
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman,

I am responding to your request for additional information on an alternative compensation path designed to offset careerist losses caused by proposed changes to the retirement system.

Enclosed is a draft paper explaining Admiral Watkins' Career Force Management and Retirement Plan. I've also included cost projections and a legislative proposal that would enact the Plan. The Plan includes a career incentive element (Individual Career Investment Account) and a retirement element (changed multipliers). Numerical values mentioned in the draft paper were calculated using Fifth Quadrennial Review of Military Compensation (QRMC) methodology. My staff is available to brief you on the Plan at your convenience.

Your interest and efforts in this matter are appreciated. I hope the enclosed information will prove useful to you.

Sincerely,

DUDLEY L. CARLSON
Rear Admiral, U. S. Navy
Deputy Chief of Naval Operations
(Manpower, Personnel & Training)

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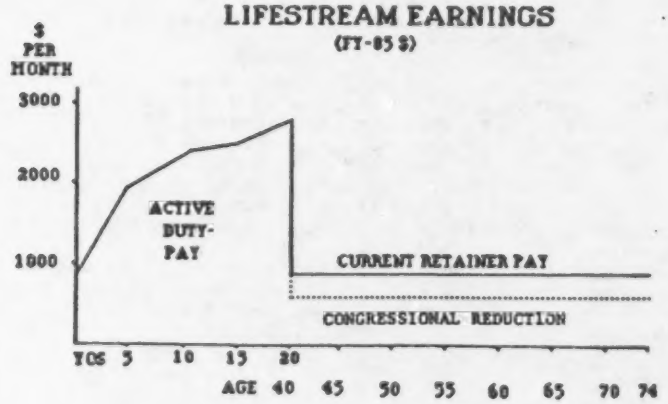
CAREER FORCE MANAGEMENT AND
RETIREMENT PLAN

The Congress has mandated a $2.9 billion reduction in the military retirement accrual fund for FY-86. This reduction requires a revision to the retirement benefit structure. Today's retirees and members of the armed forces will not be affected by the revision, but those entering military service subsequent to enactment of a revised benefit structure will come under the new system.

Historically, negative changes to active duty compensation have brought about retention losses. Likewise, it is reasonable to anticipate that reduced benefits after 20 or more years of service in the military will result in reduced quality and numbers of people opting for a military career. Couple the foregoing with the reduced attractiveness of the total military compensation package and we increase the probability of compounding accession and retention problems.

The present lifestream earnings while in the military for a typical 20 year enlisted careerist are shown in the diagram below. Likewise, by taking the $2.9 billion reduction and structurally changing the retirement system by altering the 2.5% multiplier for each year of service, it is possible to superimpose on the diagram the financial impact on future service members. For example, a Chief Petty Officer upon transferring to the Fleet Reserve with 20 years of service would have his retainer pay reduced from $802 to $546 per month for a total lifestream earnings reduction of $107,520.



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As stated earlier, Congress' reduction of $2.9 billion will come from the DOD contribution to the retirement accrual fund for military personnel coming on active duty after enactment. A majority of personnel come in the Services for a period of three years or more before facing their first reenlistment decision. This affords us the opportunity for an "optional test period" when active duty personnel could elect a new system in preference to the present one. Large numbers choosing a new, less costly system would give us needed confidence to proceed. Small numbers selecting the system would provide information needed to make pre-implementation changes to avoid career personnel shortfalls that would otherwise take years to correct.

In determining what might be an acceptable new system for testing, some basic principles apply. First, there is no free lunch -- we are getting an acceptable amount of retention for the present level of total compensation. The present system has satisfied requirements for youthful personnel; right mix of senior experienced individuals in the force; maintenance of a reasonable level of lifestream earnings for retirees; and a retirement regime that is not excessive when compared to civilian plans for occupations requiring personal sacrifice, hazardous duty, or particularly arduous working conditions. If we reduce total compensation (any element of compensation, i.e., retirement, basic pay, allowances, etc.), we will experience reductions in those choosing military careers. Thus, a $2.9 billion reduction must be offset by some increase elsewhere in the total compensation system so as to approach equal retention draw. Second, there is a personal discount rate that may be of use to us. People do value money now more than money later and, as a result, lesser amounts paid "up front" may produce equal amounts of retention. Third, it makes little sense to make changes without taking advantage of the situation to improve our ability to manage the force. This paper describes, in summary form, a CAREER FORCE MANAGEMENT AND RETIREMENT PLAN which satisfies all three principles.

Career Force Management and Retirement Plan. This new plan consists of two elements: (1) an Individual Career Investment Account (ICIA) element that replaces the "draw" to 20 years of service lost as a result of what will have to be a reduced set of multipliers, but does so at less cost due to personal discount rates, and (2) a retainer pay/retirement element with reduced multipliers (when compared to the present system) coupled with a revised multiplier structure to encourage longer service.

ICIA is a method of providing an "up front" compensatory offset for lifestream earning losses that must, unfortunately, occur. This method reduces the government's long term liability by lessening the total cost of retirement. ICIA is a

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government-funded and managed account that is the sum of government deposits in the amount of 11% of an individual's annual basic pay during each year of service 11 through 20 and interest derived from investment of the funds in U.S. Government securities. This annual deposit feature has two very attractive benefits. First, the members can watch their ICIA grow over time. Monthly Leave and Earnings Statements will contain up-to-date information on Government deposits, interest earned and the ICIA balance. Second, since deposits are tied to basic pay, there is an incentive for rapid advancement. ICIA is not vested; individuals must reach retirement eligibility to get the money. Once retirement eligibility is reached, however, annual government deposits cease and members are free to leave the money in ICIA, continuing to earn interest, or may withdraw all funds, or any portion, to use as they wish. To maintain today's continuation rates, calculations which take into account personal discount rates show that an E-7 with 20 years of service would require an ICIA of about $19,500 to offset the lifestream earning loss of $107,520 and an O-5 with 20 years of service would require about $40,000 to offset the $241,080 lifestream earning loss. These amounts are expressed in FY-85 dollars and are reached by the Government deposits of 11% of annual basic pay during each year of service 11 through 20, combined with compounded interest through the 20th year of service. For illustrative purposes, a 5% annual inflation rate, a 1.6% annual real interest rate on investments in U. S. Government securities (same rates as those used by the Department of Defense Board of Actuaries for today's retirement accrual funding) and a 5% annual military pay growth are assumed.

Representative FY-85 $ ICIA values after 20 years of service are:

E-6	$19,184
E-7	$20,752
E-8	$21,536
O-4	$39,423
O-5	$41,346

If the member remained on active duty and did not withdraw the ICIA, interest would continue to compound on these amounts, although Government deposits cease after the 20th year of service.

The Retainer/Retired Pay element is identical to the present plan in basic concept, but with major modifications to the multipliers. These modifications provide important improvements in our ability to manage the force from the 20th through 30th years of service. During years 1 through 20 the multiplier is 1.9% resulting in retainer/retired pay for 20 years of 38% of basic pay as opposed to the present system of 50%. During years 21 through 30 the multiplier will be 3.7% resulting in a 25-year figure of 56.5% vice the present 62.5% and 75% at 30 years, which is identical to the present

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Summary: This system, in theory, meets all requirements for cost effectiveness (makes the reduction required by the Congress), for retention effectiveness (retention draw has been maintained), and for force management (is an improvement over the present system). The next step should be a carefully constructed and managed test, followed by legislation to implement if found successful.

INDIVIDUAL CAREER INVESTMENT ACCOUNT COSTS (FY-85 $)

° TEST COST DEPENDENT UPON PERCENT OF MEMBERS WHO OPT FOR ICIA PLUS NEW RETIREMENT PLAN IN LIEU OF GRANDFATHERING.

PERSONNEL ACCEPTING*	FIRST YEAR DOD COST
100%	$110M
50%	$ 55M
25%	$ 27.5M

*ASSUME MEMBERS WITH 10 YEARS OF SERVICE AS TEST COHORT.

° SAVINGS TO MILITARY RETIREMENT FUND IF 100% OF MEMBERS ACCEPT.

- DOD ACCRUAL COST ATTRIBUTABLE TO FINAL PAY TEST COHORT.....$530M
- DOD ACCRUAL COST UNDER NEW RETIREMENT ($2.9B CUT).....$410M
- ACCRUAL COST SAVINGS.....$120M
- ICIA TEST COST (100% ACCEPTANCE RATE).....110M
- NET SAVINGS.....$ 10M

° SUBSEQUENT YEAR TEST SAVINGS WILL BE GREATER THAN THE TEST'S FIRST YEAR AS ADDITIONAL COHORTS ENTER THE TEST WINDOW.

° AGAINST THE $2.9 BILLION RETIREMENT SAVINGS, DOD'S STEADY-STATE COST FOR ICIA WOULD BE ABOUT $800 MILLION IN FY-85 DOLLARS.

Honorable George Bush
President of the Senate
Washington, DC 20510

Dear Mr. President:

Enclosed is a draft of legislation, "To amend title 37, United States Code, by adding chapter 8, to revise the pay and allowances of members of the armed forces to provide a program of deferred compensation for career military personnel who serve 20 or more years of active duty."

The proposal is part of the Department of Defense Legislative Program for the 99th Congress. The Office of Management and Budget advises that, from the standpoint of the Administration's program, there is no objection to the presentation of this proposal for the consideration of the Congress. It is recommended that the proposal be enacted by the Congress.

Purpose of the Legislation

The purpose of this proposal is to create an Individual Career Investment Account (ICIA) for military members whose longevity and progression within the force indicate an intention to remain in the military service until at least initial voluntary retirement eligibility. The ICIA provides an "up front" compensatory offset for lifestream earning losses that will occur as a result of funding reductions in the military retired and retainer pay accrual ($2.9 billion reduction in the FY 1986 Department of Defense Authorization Act).

This proposal provides a solution to the decreased attractiveness of military service resulting from a significant reduction in military compensation. The ICIA is a strong force management tool to "buy back" the personnel losses that will occur. The Services cannot afford a repeat of the career force losses which occurred in the mid to late 1970s, when current compensation lagged private sector wage growth. The reduction in the value of the military retirement system portends similar circumstances if not blunted. The ICIA offsets this reduction through "government-funded savings accounts" available upon the completion of 20 years of active service.

Under the proposed legislation, a government-funded account in the individual's name is established once the member completes ten

years of active duty. Ten annual deposits will be made, on behalf of the individual, for each year of service from the eleventh through completion of 20 years of service. Deposits cease and the member is vested with the account balance after completing 20 years of service. The basic deposit will be determined annually by the Secretary of Defense based upon modeling of a percentage of military basic pay which is needed to overcome the adverse force manning impact associated with the reduction in retired and retainer pay. Interest on the account maintained by the Treasury will be a function of current Treasury Bill rates although no actual securities are bought and sold (concept of a "savings account" as discussed and endorsed by the Government Accounting Office in its report B-154394, 10 January 1975).

The Department plans a test of this concept once enacted. During the three year test period, the Department would offer all those completing the tenth year of service the option of:

- remaining with the current retirement system (2 1/2 percent multiplier for each year of service through 30 years with a maximum of 75 percent); or

- selecting the ICIA and revised retirement system (reduced multipliers of 1.9 percent for each year of service through 20 and 3.7 percent for each year 21 through 30).

Acceptability of the revised system by today's force will provide needed information on the plan's viability as a means to prevent unacceptable losses in military personnel from the force.

Cost and Budget Data

The enactment of this proposal will approach $800 million for contributions in the steady state once all military members with ten to 20 years of service come under the plan.

Sincerely,

Honorable Thomas P. O'Neill
Speaker of the House of Representatives
The United States Capitol Building
Washington, DC 20510

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Sincerely,

SECTIONAL ANALYSIS
OF A BILL

To revise the pay and allowance of members of the armed forces to provide a program of deferred compensation for career military personnel who serve 20 or more years of active duty.

The first section of the bill would amend title 37, United States Code, by adding a new chapter 8 to that title which would be entitled "Individual Career Investment Accounts." The new chapter 8 would contain nine new sections, numbered 451-459, as follows:

Section 451 would provide eight definitions which would be applicable throughout the new chapter 8. The first definition, "basic deposit" describes the formula for determining the Government's deposit to the Fund, established elsewhere in chapter 8, which would form the corpus of the Fund used to pay qualified members deferred compensation. The basic deposit, with respect to a particular eligible member for a particular fiscal year, would be the product of (1) all basic pay paid to that member and (2) a deposit percentage, established by the Secretary of Defense, for each fiscal year.

The second definition which would be established by section 451 would be that of "deposit percentage," which would be defined as the single percentage established by the Secretary of Defense to be effective as of October 1 of each fiscal year. In establishing that percentage, the Secretary of Defense would seek to determine the level of funding which he believes to be necessary, in light of all facts and circumstances, to insure a satisfactory level of retention among the career force through use of the deferred compensation program which would be established by the bill.

The third definition is that of "creditable service," which would be used solely for determination of when a member of the armed forces is entitled to have established an Individual Career Investment Account (hereinafter "Account") and to have funds deposited in the central Fund for his possible future use. The term "creditable service" would include only periods of service on active duty in some status as a member of an armed service.

The fourth definition is that of "eligible member," who is a member entitled to have an Account established and to have deposits made in his behalf for his possible future use. A person becomes an eligible member by first entering active duty after the effective date of the [military retirement system amendments of 1986] and by serving at least 10 years of active duty.

The fifth definition would be that of "Fund," which would mean the Individual Career Investment Account Fund, established

elsewhere in new chapter 8 of title 37, which would exist on the books of the Treasury and be used for the accumulation of assets from which would be paid the deferred compensation established by the new chapter.

The sixth definition would be that of a "qualified member." This category of persons would include those members or former members of the armed forces who are or were eligible members and who either (1) are eligible to receive retired pay under some provisions of law other than chapter 67 of title 10, United States Code (Retired Pay for Non-Regular Service); or (2) have completed 20 or more years of creditable service but are not yet eligible to retire because they have not completed 10 years of active commissioned service as required by various sections of law.

The seventh definition would be that of "required deposit" which would mean, with respect to an eligible member, the basic contribution for that member.

The final definition would be that of "retired pay" and would provide that the term includes retainer pay.

The second section of the new chapter 8, section 452, would provide for the establishment on the books of the Treasury of a fund known as the Individual Career Investment Account Fund (hereinafter "Fund") which would be used to accumulate assets for the payment of the deferred compensation provided by the new chapter. The assets of the Fund would be the Government deposits paid into the Fund and the interest paid on the assets. Subsection (c) of section 452 would provide that the assets could be used to pay only the deferred compensation established by new chapter 8, and the assets would be made available for that purpose. Subsection (d) of section 452 would establish the concept that the deposits paid into the Fund are for the benefit of eligible members who ultimately vest in the program by attaining qualified status. However, that subsection would make it clear that if and only if an eligible member attains qualified member status (generally by serving at least 20 years active duty or by being retired at some earlier point for disability) does that member have any legal or equitable right or interest in any of the assets of the Fund. Finally, subsection (e) of section 452 would permit the Secretary of the Treasury to comingle the assets of the Fund (but not with any other monies) and would provide specifically that the Treasury need not maintain separate accounts of assets of the fund in the names of the individual members. That separate accounting responsiblity is, however, assigned to the Secretaries concerned elsewhere in new chapter 8.

The next section of new chapter 8, section 453, would provide procedures for the growth of the Fund assets. Subsection (a) of section 453 would require the Secretary of the Treasury, no later than the 30th day of the second month following the month for which

the interest deposit corresponds, to transfer, from funds appropriated for that purpose, an amount equal to the product of the total assets of the Fund for that month and the rate of interest payable on the securities of the United States having a maturity of six months and sold most recently prior to September 1st for the following six month period of October 1st through March 30th and sold most recently prior to March 1st for the following six month period of April 1st through September 30th. This would insure growth rate of the Fund assets equal to the interest rate paid by the United States on its six month securities at certain times during each year. Subsection (b) of the section would specifically prohibit the investment of Fund assets or any other use of those assets except for the payment of the deferred compensation established by new chapter 8.

Section 454 of new chapter 8 would direct that, under uniform regulations of the Secretary of Defense, each Secretary concerned would establish and maintain a separate Account for each eligible member under his jurisdiction. Such an Account would constitute each eligible member's attributable share of the Fund assets; that is, the required deposits made on behalf of that member and the growth of those deposits through interest paid.

Section 455 would establish the deposit payment mechanism through which the Fund assets would be accumulated. Subsection (a) would require each Secretary concerned to deposit, not later than the 30th of each month, an amount equal to the sum of all required deposits for eligible members under the Secretary's jurisdiction. These deposits for the previous month are based upon the individual eligible servicemember pay accounts for that preceding month. Those amounts would come from funds appropriated specifically for that purpose. Subsection (b) would require that amounts only be deposited for eligible members who were on active duty and not yet qualified members as of the first of the month in question. That is, if a member serving on active duty completed 20 years of service on August 1st, no deposit attributable to that member need be made on September 30th for the month of August, whereas if that member became a qualified member on August 15th, a deposit would be made on September 30th for the period August 1st through August 14th. In short, Government contributions cease at the 20 years of service point for all members, but growth from interest will continue so long as the Account is not closed.

Section 456 of new chapter 8 would require each Secretary concerned to furnish each member a report on the status of that member's Account not later than December 1 of that year, provided the Account is not closed as of that date. That report must include at least:

(1) the amount of the deposits for the preceding year which were made to the Fund for that member's benefit for the basic pay earned through the September 30th of that year;

(2) the total of all deposits made to the Fund for that member's benefit;

(3) the rates of interest applicable to the Fund assets for the two six month periods of October 1st through 30th March and April 1st through September 30th and the dollar amount of growth of the assets of the Fund which are held for the benefit of that member resulting from those rates of interest;

(4) the total dollar amount of all funds held for the member's benefit by the Fund as of September 30th of that year, including that year's deposits and growth; and

(5) in the case of a qualified member, an accounting of any funds withdrawn by that member from his Account.

Section 457 of new chapter 8 would provide procedures for the payment of assets of the Fund to qualified members and in certain other circumstances. Subsection (a) provides that when a qualified member actually retires and begins receiving retired pays, that member shall be paid an amount equal to the total assets of the Fund attributable to that member and represented by the total value of the member's Account immediately preceding the date the member begins receiving retired pay. Payment of that amount closes the member's Account and terminates all rights of the member in Fund assets and all obligations of the United States to the member under new chapter 8. A member who retires and begins receiving retired pay does not have the option of keeping his Account open, or of reopening another Account in the event of recall to active duty.

Subsection (b) of section 457 provides that any qualified member who has not retired and is not receiving retired pay shall be paid, upon the member's request, part or all of the Fund assets attributable to the member immediately preceding the member's request. Partial withdrawals are permitted, however such withdrawals may not be less than 10 percent of the member's total Account value. When the Account has been depleted, either through a single full or several partial withdrawals, the member's Account is closed and all rights and obligations expire under new chapter 8. Since the sources of Fund assets are Government deposits and interest growth, a qualified member may not repay any amounts withdrawn, nor may an Account be reopened after it is closed.

Subsection (c) of section 457 provides that upon receipt of proof of death of a qualified member whose Account is not closed, the amount represented by that member's death shall be paid to the member's estate, and upon such payment the Account is closed and all rights and obligations under new chapter 8 are extinguished.

Subsection (d)(1) of section 457 provides that, in the case of an eligible member who either dies while on active duty before becoming a qualified member, or is a disability retiree under chapter 61, title 10, United States Code, before becoming a qualified member, the amount represented by the member's Account immediately before the member's death or disability shall be paid to the member's estate or the disabled member. Such a payment closes the account and extinguishes all rights and obligations under new chapter 8.

Subsection (e) of section 457 provides that payments under that section would be made by the Secretary of the Treasury upon the certification by the Secretary concerned of the name of the payee and the amount to be paid. Subsection (f) of the section would require the Secretary concerned to provide a written notice to eligible members approaching the time when they would become qualified members of the options available to qualified members to receive payments under new chapter 8. Finally, subsection (g) of section 457 would provide that determinations and certifications made by a Secretary concerned under new chapter 8 are conclusive, but that when warranted by the circumstances, the Secretary may reconsider such decisions and change or modify them.

Section 458 of new chapter 8 would provide special rules for the treatment of payments made under that chapter for purposes of the Internal Revenue Code. Subsection (a) provides that no funds represented by an eligible member's Account shall be considered as gross income to that member. Subsection (b) would provide similar treatment for funds represented by a qualified member's Account immediately before the member became qualified. Subsection (c) would provide similar treatment for funds paid to a member's estate under section 457(d) of new chapter 8. Subsection (d)(1) would provide, in cases of payments closing the Account of a retired qualified member, total single payments of a non-retired qualified member, or payments closing the Account of a deceased qualified member or disability retirement members, that, and only that, portion of the payment which represents growth in the Account since the member became qualified shall be treated as interest earned in the year of payment. Subsection (d)(2)(A) provides that in cases of initial payments to non-retired qualified members of less than the total amount of an Account, any payment amount which exceeds the Account balance of the member the date the member became qualified shall be deemed interest earned in the year of such payment. Subsection (d)(2)(B) provides that in the case of any subsequent payments from such an Account shall be deemed interest earned in the year of that subsequent payment when the cumulative payment amount exceeds the balance in the member's Account the day before the member became qualified. Subsection (e) would provide that no portion of any payments reflecting the Government's deposit attributable to a member would ever be considered gross income to a member or member's estate for Federal income tax purposes.

Finally, section 459 of new chapter 8 would provide that the chapter be administered under regulations of the Secretary of Defense for personnel subject to his jurisdiction, and of the Secretary of Transportation for the Coast Guard, and that such regulations insure, to the maximum extent feasible, that the chapter is administered uniformly among the armed services.

Subsection (b) of section 2 of the bill would amend the table of chapters at the beginning of title 37, United States code, to reflect the addition of chapter 8, as would be added by the bill.

Section 3(a) of the bill would provide that the amendments made by the bill become effective not later than October 1st of the year following the year in which the bill was enacted. Subsection (b) of that section would provide that the first Government deposit which would be required by section 455 of title 37, as added by the bill, would be required to be made not later than the 30th of the month following the month when the provisions of the Act become effective.

A BILL

To revise the pay and allowances of members of the armed forces to provide a program of deferred compensation for career military personnel who serve 20 or more years of active duty.

Be it enacted by the Senate and House of Representatives of the United states of America in Congress assembled, that this Act may be cited as the Individual Career Investment Accounts Act.

Sec. 2.(a) Title 37, United States Code, is amended by inserting after chapter 7 the following new chapter:

"CHAPTER 8 - INDIVIDUAL CAREER INVESTMENT ACCOUNTS

"Sec.

"451. Definitions.
"452. Establishment and purpose of Fund.
"453. Interest on assets of Fund.
"454. Establishment of Individual Career Investment Accounts.
"455. Payments into fund.
"456. Reports on Individual Career Investment Accounts.
"457. Payments from Fund.
"458. Treatment under the Internal Revenue Code of 1954.
"459. Administration.

"451. Definitions

In this chapter:

"(1) 'Basic deposit', with respect to an eligible member for a fiscal year, means the amount that is the product of--

"(A) the deposit percentage established by the Secretary of Defense for that fiscal year; and

"(B) the total amount of basic pay paid to such member during the period.

"(2) 'Deposit percentage' is the single percentage amount established as of October 1 of each fiscal year by the Secretary of Defense as being the percentage amount which will result in the level of funding of Individual Career Investment Accounts needed to insure a satisfactory level of retention on active duty of eligible members.

"(3) 'Creditable service' means the years of service computed by adding all periods of active service as an officer, Army field clerk, flight officer, aviation midshipman, or enlisted member of a uniformed service.

"(4) 'Eligible member' means a member of the armed forces who --

"(A)"(i) first entered active duty after the effective date of [the military retirement system amendments of 1986]; and

"(B) has 10 or more years of creditable service.

"(5) 'Fund' means the fund established on the books of the Treasury by section 452 of this title and known as the Individual Career Investment Account Fund.

"(6) 'Qualified member' means a member or former member of the Armed forces who is or has been an eligible member and who--

"(A) has become eligible to receive retired pay under other than chapter 67 of title 10; or

"(B) has completed 20 or more years of creditable service but is not eligible to retire because he has not completed 10 years of active commissioned service.

"(7) 'Required deposit', with respect to an eligible member, means the basic deposit required for such member.

"(8) 'Retired pay' includes retainer pay.

"452. Establishment and purpose of Fund

"(a) There is established on the books of the Treasury a fund to be known as the Individual Career Investment Account Fund (hereinafter in this chapter referred to as the "Fund") which shall be administered by the Secretary of the Treasury. The Fund shall be used for the accumulation of funds to pay to qualified members the proceeds represented by Individual Career Investment Accounts established for such members under section 454 of this title.

"(b) There shall be deposited into the Fund the following, which shall constitute the assets of the Fund:

"(1) Amounts paid into the Fund under section 455 of this title.

"(2) Interest payable on assets of the Fund.

"(c) There shall be paid from the Fund only those amounts which are authorized to be paid under section 457 of this title, and the assets of the fund are hereby made available for such purpose.

"(d) Funds deposited into the Fund shall be held in trust for those eligible members for whom such deposits were made and who become qualified members. However, until such time as an eligible member becomes a qualified member, such an eligible member shall have no legal or equitable right to or control over any assets of the Fund.

"(e) Notwithstanding subsection (d) of this section, the Secretary of the Treasury may comingle funds deposited in the Fund for the benefit of eligible members who become qualified members, and need not maintain a separate accounting of such funds for each individual for whose benefit such funds were deposited.

" 453. Interest on assets of Fund

"(a) Not later than the 30th day of the second month following the month for which interest deposits correspond, the Secretary of the Treasury shall transfer to the Fund, from funds appropriated for such purpose, an amount that is equal to the product of--

"(1) the total of all assets of the Fund on the last day of month to which the interest applies; and

"(2) the rate of interest payable by the United States

on its securities having a maturity of six months sold most recently prior to September 1 for the following six month period beginning on October 1 and ending March 30, and most recently prior to March 1 for the following six month period beginning on April 1 and ending on September 30.

"(b) The assets of the Fund may not be invested or used for any purpose other than to make payments as provided by section 457 of this title.'

" 454. Establishment of Individual Career Investment Accounts

"Under uniform regulations prescribed by the Secretary of Defense, the Secretary concerned shall establish and maintain for each eligible member under his jurisdiction an Individual Career Investment Account. Each such Account will represent the funds paid under section 455 of this title by the Secretary concerned into the Fund for the benefit of such member, along with the interest paid on such funds pursuant to section 453 of this title.

" 455. Payments into Fund

"(a) Not later than the 30th of each month and corresponding to amounts due for the previous month, the Secretary concerned shall deposit in the Treasury of the United States to the credit of the Fund an amount equal to the sum of all required deposits for eligible members described in subsection (b) of this section under his jurisdiction. Amounts paid into the Fund under this section shall be paid from funds

appropriated for such purpose.

"(b) Deposit of required deposits will be made under subsection (a) of this section for a respective month only for eligible members who were on active duty and not qualified members.

" 456. Reports on Individual Career Investment Accounts

"(a) Not later than December 1 of each year, the Secretary concerned shall furnish to each eligible member for whom a deposit was required to be made by section 455(b) of this title and to each qualified member whose Individual Career Investment Account is not closed as of that date, a report setting forth the following:

"(1) The amount of the basic deposits made to the Fund during such year attributable to such member.

"(2) The total amount of all required deposits made to the Fund attributable to such member.

"(3) The rate of interest applicable to the Fund assets for the six month period specified in section 453 of this title and the amount of interest credited for those periods on the funds contained in the Fund attributable to such member.

"(4) The total of all funds (including all required deposits and interest payable on such deposits) contained in the Fund which are attributable to such member and represented by such member's Individual Career Investment Account.

"(5) In the case of a qualified member, the total of all

funds withdrawn, if any, by such member from his Individual Career Investment Account.

" 457. Payments from Fund

"(a) The Secretary concerned shall, at the time a qualified member begins receiving retired pay, cause to be paid from the Fund to such member the amount represented by such member's Individual Career Investment Account immediately preceding the member's inital receipt of retired pay. Upon such payment, that member's Account shall be closed, and the member has no further right or interest in the Fund.

"(b) The Secretary concerned shall, within 90 days after receipt of a written request from a qualified member not receiving retired pay, cause to be paid from the Fund to such member the amount represented by such member's Individual Career Investment Account immediately preceding the date of such member's request, or such lesser amount (but not less than 10 percent of the total amount represented by such Account) as specified by such member in that request. Any amounts so paid shall be deducted from the member's Individual Career Investment Account and shall be reflected in any report required to be furnished to the member under section 456 of this title. When the total amount represented by the member's Individual Career Investment Account has been paid to such member, that member's Account shall be closed, and the member has no further right or interest in the Fund.

"(c) Upon receipt of satisfactory proof of death of a qualified member whose Individual Career Investment Account is not closed, the Secretary concerned shall cause to be paid, within 90 days after receipt of such proof, to the estate of such member the amount represented by such member's Individual Career Investment Account immediately preceding the date of death of such member. Upon such payment, that member's Account shall be closed, and the member's estate has no further right or interest in the Fund.

"(d) Upon receipt of satisfactory proof of death while serving on active duty of an eligible member who was not a qualified member, or disability retirement under chapter 61, title 10, United States Code, of an eligible member who was not a qualified member, the Secretary concerned shall cause to be paid to the estate of such member, or to such disability retired member, the amount represented by such member's Individual Career Investment Account immediately preceding the date of death or disability of such member. Upon such payment that member's Account shall be closed, and the member's estated or disability retired member has no right or interest in the Fund.

"(e) The Secretary concerned shall cause payments to be made under this subsection by certifying to the Secretary of the Treasury the identity of the member or the member's estate to be paid and the amount to be paid.

"(f) The Secretary concerned shall provide notice to each eligible member who is within two years of becoming a qualified member of such member's options under this chapter. The notice must be sent in writing to the member concerned not earlier than two years or later than one year before such member is expected to become a qualified member.

"(g) Determinations and certifications made by the Secretary concerned as to the entitlement of any person to receive payments under this chapter and the amount of such payments are conclusive. The Secretary concerned may, when warranted by the circumstances, reconsider a determination or certification made under this chapter, and change or modify it.

" 458. Treatment under Internal Revenue Code of 1954

"(a) No part of the funds represented by an Individual Career Investment Account of an eligible member who is not a qualified member shall be included within the gross income of such member under section 61 of the Internal Revenue Code of 1954.

"(b) No part of the funds represented by an Individual Career Investment Account of a qualified member immediately before the date such member became a qualified member shall be included in the gross income of such member under section 61 of the Internal Revenue Code of 1954.

"(c) No part of any payment made to an eligible member's estate pursuant to section 457(d) of this title shall be

included in the gross income of such member or such member's estate under section 61 of the Internal Revenue Code of 1954.

"(d)(1) In the case of a payment to--

"(A) a qualified member pursuant to section 457(a) of this title;

"(B) a qualified member of the total amount represented by such member's Individual Career Investment Account pursuant to section 457(b) of this title when no previous payments have been made; or

"(C) the estate of a qualified member pursuant to section 457(c) of this title,

the portion of such payment which exceeds the funds represented by such member's Individual Career Investment Account immediately preceding the date such member became a qualified member shall be treated, for purposes of section 61 of the Internal Revenue Code of 1954, as interest to that member or to the member's estate, as the case may be, earned in the year such payment was made, and no other portion of such payment shall be included in the gross income of the member or member's estate, as the case may be, for purposes of that section.

"(2)(A) In the case of an initial payment to a qualified member under section 457(b) of this title of an amount less than the total amount represented by such member's Individual Career Investment Account, that portion of the funds which exceeds such member's Individual Career Investment Account

balance the date such member became a qualified member shall be treated, for purposes of section 61 of the Internal Revenue Code of 1954, as interest to that member earned in the year such payment is made.

"(B) In the case of any subsequent payment made to a qualified member under section 457(b) of this section after an initial payment described in subparagraph (A) of this paragraph has been made, that portion of the funds which represent cumulative payment which exceeds such member's Individual Career Investment Account on the day before the date such member became qualified shall be treated, for purposes of section 61 of the Internal Revenue Code of 1954, as interest to the member earned in the year such subsequent payment is made.

"(e) In no case shall that portion of any payment made to a qualified member, to the estate of a qualified member or of an eligible member, or to an eligible but non-qualified disabled member, which represents the required deposits made by the Secretary concerned for the benefit of such member be included in the gross income of the member or the member's estate, as the case may be, for purposes of section 61 of the Internal Revenue Code of 1954.

" 459. Administration

"The Secretary of Defense (and the Secretary of Transportation with respect to the Coast Guard) shall prescribe regulations for the administration of this chapter. Such regulations

shall ensure, to the maximum extent feasible, that this chapter be administered uniformly within the armed forces.".

(b) The table of chapters at the beginning of such title is amended by inserting after the item relating to chapter 7 the following new item:

"8. Individual Career Investment Accounts.....451".

Sec.3.(a) The amendments made by this Act shall take effect not later than October 1st of the year which immediately follows the year of enactment of this Act.

(b) The first deposits required to be made under section 455 of title 37, United States Code, as added by this Act, shall be made not later than the 30th day of the month following the month when the provisions of the Act become effective.

Senator WILSON. Senator Glenn?

Senator GLENN. Thank you, Mr. Chairman.

One of the ways people compare retirement systems is on the basis of the percentage of today's payroll that would have to be set aside to pay retirement benefits in the future. The percentage is usually referred to as normal cost percentage.

What is the normal cost percentage of the military retirement system today? Do you have those figures?

General CHAVARRIE. Yes, sir. It is 50.7.

Senator GLENN. What would those normal cost percentages be under your two options to reduce down to 2.9?

General CHAVARRIE. Under the structure option, it is 42.5. Under the combination it is 42.6. It comes down about 8 percent, 7 percent. From 50.7 it comes down to 42.5.

Senator GLENN. We recently put in a new system for the Civil Service system which would lower the normal cost percentage for Civil Service retirement from 25 to 21.9.

Is the current 50, whatever the figure was you gave a moment ago on the normal cost percentage or the military figure you mentioned for that, for the military retirement system comparable to either the 25 or 21.9 figure for Civil Service retirement?

General CHAVARRIE. As you know, retirement is based on base pay. If you take the total pay and look at it, the comparable number is 29 percent.

Senator GLENN. That was the figure I wanted to get on the record because we have had comments on the floor in the past, if you figure everything on the same basis, the military would be at 29 percent compared to the civilian 21.9 now.

General CHAVARRIE. That is correct.

Senator GLENN. Is that 29 before any change or is that after the change?

General CHAVARRIE. That is the current system which is high three.

Senator GLENN. Where would we be if we made the change, either one of the options you are talking about?

Would your overall compensation, your overall percentage, still be 29?

General CHAVARRIE. Yes, sir.

You had better ask the question again.

Senator GLENN. I see a lot of heads shaking behind you.

General CHAVARRIE. Please ask your question again.

Here it is, 24 instead of 29.

Senator GLENN. Instead of 29, it would be 24. So, compared to the Civil Service, they have a 29.9, now you have 24, if you consider overall active duty military compensation?

General CHAVARRIE. That is correct.

Senator GLENN. That is not too far apart, then.

I have questions on the chart on the adjustment of the 40th anniversary. I do not know whether that was made up to be as onerous as possible or not, but that seems to be rather unfair to take that to the fortieth anniversary.

If the person lived to be 100 years of age, to use an example, he is going all the way down. When he needs the money worst of all, he gets the least of all.

General CHAVARRIE. At age 80 he gets $499 a month. If you are going to kick off, you had better do it at the 40th anniversary and rack up on that step. It is a bad time just before doing that.

Senator GLENN. I thought there were a lot of other ways it could be done better than that one-time adjustment at the 40th anniversary.

General CHAVARRIE. We could have done it a lot of ways, but we were constrained by the 2.9 figure. That is what we had to come up with. That is what it takes to get to the 2.9. That is the insidious nature of inflation.

Senator GLENN. We defined insidious, did we not?

Senator WILSON. I would like to look at the life expectancy, not in an actuarial sense, but to the particular officer making that recommendation, if you find he is from long-life stock.

Senator GLENN. One other point. The Department report does not recommend enactment of any new authority to pay bonuses or special pays.

Do you have the authority now to make the payments that would be necessary to compensate in whatever way possible and would like only the appropriated money to make those changes?

Do you have the authority to do that now?

General CHAVARRIE. That is correct. We do have that authority. Whatever change occurs, we have been looking at that very carefully and will come back to you.

Senator GLENN. You would not need new authority? What you need is dollars to do it?

General CHAVARRIE. That is right, we do not need new authority.

Senator GLENN. We might want to have some people submit things for the record. We would appreciate it if you could submit those to us, please.

I would ask unanimous consent that we keep the record open for the normal time period.

Senator WILSON. Without objection, that will be the order.

We thank you for your generosity this afternoon and look forward to additional cooperation. We may see a lot of you between now and the first of the year, or whatever earlier time Congress ceases to be in session.

General CHAVARRIE. We pledge our cooperation with the staff, sir.

Senator WILSON. Thank you very much.

[The prepared statements of the Retired Officers Association and the Non-Commissioned Officers Association of the United States of America follow:]

PREPARED STATEMENT OF COL. GEORGE F. HENNRIKUS, JR., USAF, RETIRED, DIRECTOR, LEGISLATIVE AFFAIRS, THE RETIRED OFFICERS ASSOCIATION

Mr. Chairman and members of the Committee: I am Colonel George F. Hennrikus, Jr., director of Legislative Affairs of the Retired Officers Association (TROA) which has its national headquarters at 201 North Washington Street, Alexandria, Virginia. Our association has a membership of over 345,000 retired, former and active duty officers of the seven uniformed services. Included in our membership are 41,577 widows of former members.

As I prepared this testimony and reflected on my 30 plus years of military service, one nagging concern kept surfacing and I'll present it for your consideration. I wonder how many of the brave men and women, who responded so selflessly to this Nation's call during three bitter conflicts, and then were motivated to complete a

military career, would reconsider their career decisions if they were promised "one-fourth pay" after 20 years of service (YOS). Some who were endowed with extraordinary patriotism undoubtedly would have—but I suspect the vast majority would have turned to less arduous and more rewarding careers in private life.

Yet, "one-fourth pay" is precisely the disincentive that military recruiters and, of vital concern, career advisors will be confronted with as their primary retention incentive in the future. That figure seems startling, yet OSD analysis reveals that the degradation in retired pay required to achieve the $2.9 billion reduction in FY 1986 Department of Defense retired pay accrual costs mandated by Congress, would reduce the retired pay of a 20 year enlisted retiree (E-7) to 25 percent, one-fourth, of final pay under the structural option (i.e. HI-5 [60 month] averaging and reduced multiplier) and 27 percent of final pay under the combination option (i.e. reduced multiplier and CPI-1 for life with one time restoral at the 40th anniversary of entry in service). Even at the 30 year point the percentages increase to only 46 percent and 50 percent for the structural and combination options respectively. The grim reality is that even these percentages are overstated since special and incentive pays and promotions are excluded from the analysis.

Relying again on OSD analysis, it is important to underscore the significant losses of experienced officers, non-commissioned officers and petty officers that would result from retirement reductions of this magnitude. Relative to today's force, there would be 44,000 to 45,000 mid-grade (11-20 YOS) losses or approximately 11 percent. For the senior force (21-30 YOS) losses would approximate 22,000-23,000 or about 30 percent. Such an unprecedented loss in leadership capability and hands on technical expertise would undermine combat readiness if not offset by other incentives. However, the near tragic experience of the late 1970's suggests that the administration and Congress will be reluctant to develop the necessary incentives until a manpower crisis develops.

Therein lies the problem: Significant losses of experienced and talented leaders will occur. Even if the service recruiters were able to respond to the increased accession demands—more than 20,000 by OSD estimates—raw recruits can't replace seasoned veterans. In testimony before the House Armed Services Committee earlier this year, General Charles A. Gabriel, Air Force Chief of Staff, graphically illustrated the readiness implications of losing experienced people. He emphasized that if the Air Force loses an F-16 pilot with 8 years of experience and 1,700 flying hours, it will take 18 months to replace him with a new lieutenant with 275 hours and no experience in overseas theaters of operation. And, it would cost $1.6 million to train him to the relatively novice state. As a further diseconomy, it will be years before the new lieutenant can fly the F-16 with the expertise necessary to take advantage of the combat potential paid for when the government bought the airplane.

The services are able to accomplish their missions because they have well-trained, high quality, highly motivated and totally dedicated people who are committed to a strong defense. The "quid pro quo" is a strong commitment by service leaders to provide a fair, consistent and stable entitlements package. For more than three decades—until the persistent erosion started with HI-3 averaging in 1980—the military retirement system was the bedrock and cornerstone of the entitlements package.

Despite those changes which are conservatively in the 8-15 percent range, the military retirement system is the "light at the end of the tunnel"—a pressure relief valve—which enables many careerists to endure the extraordinary demands of military service: Frozen flightlines in sub-freezing weather; protracted deployment on the open and hostile sea; field duty in jungles, deserts and mountainous terrain; enforced family separations; frequent PCS moves, often with minimal advance notice, uprooting families and losing second incomes; abridgment of freedom of speech and political activity; and unconditional obligation to give their lives for their country. If the retirement system is reduced the 16 percent now proposed, in addition to dramatic reductions which have already occurred, its ability to ameliorate the adverse experiences of a military career will be severely diminished.

Grandfathering the current force as specified in the FY 1986 Defense Authorization Act must remain an inviolate imperative throughout the deliberations on this critical issue. Reinforcing this principle from the outset will help reduce the concern and uncertainty surrounding the issue and hopefully put to rest the speculation that the resulting legislation will "break faith" or renege on commitments already made.

One of the adverse side effects of grandfathering will be the creation of a third class of military members for years to come. The principal impacts will be on career motivation. We can hardly expect retirees or the more senior officers and non-commissioned officers to cite the stability of the military retirement system as a major

factor in urging younger, high quality officers and enlisted members to opt for a military career.

The Retired Officers Association is strongly opposed to further changes in the military retirement system. Without substantial improvements in other elements of the total entitlements package, both options will result in unacceptable force structure. Nevertheless, we would be shirking our responsibility if we did not offer our views on the options before you. After extensive discussions with the services personnel managers and analysts it is our assessment that the combination option is the lesser of two evils:

Combination option minimizes impact on readiness because it reduces average lifestream earnings less;

Structural option is subject to larger losses under high inflation and wage increases; makes retired pay subject to variables such as economic conditions and promotion timing (which differs by branch of service);

Structural option results in different percentage impact (lifestream loss) depending on grade at retirement and is generally more severe for enlisted force;

Combination option has a greater career draw because it provides higher beginning retired pay at 20 YOS;

Combination option provides retirees higher initial retired pay and higher pay at start of true retirement (age 62-65);

Loss of purchasing power due to COLA cap in combination option is gradual, permitting improvements in second career earnings to offset this effect.

Our bottom line—TROA is deeply concerned that the purported retirement reform is being driven by an arbitrary decision to reduce FY 1986 accrual costs by $2.9 billion. Such a finite number suggests that precise analysis has been employed to determine what degree the system should be cut to produce the optimal force structure. Yet, not only does no such analysis exist, but change flies in the face of the recommendations of this Nation's most senior military advisors. In fact, use of "Kentucky windage" to reduce the most vital element of the entitlements package to "one-fourth pay" may prove to be a gamble with national security and a legacy future Congresses may sorely regret.

As a final point, Mr. Chairman, during hearings on the survivor benefit plan (SBP) earlier this year, you and the witnesses discussed the need to address the possible degradation in SBP annuities as a result of impending retirement changes. That need will become acute if either of the retirement options now under consideration is enacted. The following table will help illustrate the gravity of the situation, using an E-7 with 20 years of service as an example and the 55/35 two tier system (monthly payments).

Survivors age	Current system	Structure only	Combination
Under 62	$454	$329	$361
62 and over	289	209	229

Even under the current system, the $289 second tier for survivors over 62 is woefully inadequate. The future range of $209-$229 would be patently unfair to military survivors. Therefore, we strongly recommend that the committee seriously consider re-designing the SBP to provide survivors a single tier equivalent to 50% of the retired pay base, regardless of the survivors age. This would parallel the SBP annuity being considered for Federal civilians under their new retirement system for entrants after 1983 and should not cost substantially more than the current system.

In summary, TROA is adamantly opposed to the changes in the retirement system being considered by this committee. If enacted, either plan would have a devastating effect on our ability to deter war. Action to correct the resultant deterioration would be both ineffective and costly.

Whatever changes are made in the military retirement system, there must be assurances that the value of the revised system is guaranteed beyond the point at which the individual is no longer able to control his own destiny. The retirement system is perceived by service members to be an implied contract, and they must have the assurance that if they commit the best years of their lives to a military career, the value of their retirement system will not be eroded once they have fulfilled their commitment. The current and future members of this committee have

the responsibility to fulfill the terms of that contract by insuring that the value of the benefits promised implicitly or directly be maintained and realized as a government obligation at some future date—twenty, thirty or forty years from now.

We appreciate the opportunity to express our views. We fully recognize the tough decisions confronting Congress in attempting to come to grips with the budget deficit but urge you to make national security the overriding consideration in your deliberations.

PREPARED STATEMENT OF SGT. MAJ. C.A. "MACK" MCKINNEY, USMC RET., LEGISLATIVE COUNSEL, NON COMMISSIONED OFFICERS ASSOCIATION OF THE UNITED STATES OF AMERICA

Mr. CHAIRMAN. The Non Commissioned Officers Association of the USA has had the opportunity to review the two options submitted by the Department of Defense in compliance with section 667 of the Fiscal Year 1986 Defense Authorization Act (P.L. 99-145). The Association considers both proposals to be especially unacceptable to the enlisted career force of the future. The two options blatantly ignore the human needs of those commissioned and noncommissioned officers reaching their terminal grades prior to attaining eligibility for retirement and, because of their more junior grade, may be encouraged to retire at 20 years of creditable service.

Current military pay scales, which apparently are not under consideration for change, offer no incentive for retention beyond 20 years of service for pay grades 0-4 and E-6 and below. There are no longevity pay increases for those grades after attaining the 18th year of service.

Upon retirement, military personnel in those grades face the necessity of finding civilian employment in order to provide for their families. The options under consideration would cause greater hardships for these servicemembers because of the loss in income especially during the first year of retirement. This is the most crucial period in the retirement cycle as most servicemembers must relocate, find civilian housing and employment, enroll their children in school and become settled in a new community. The need for financial security is greater in the first year than at any other time during the post-service period.

The two proposed options would reduce the amount of retired pay for this group of servicemembers. An E-6 retiring at 20 years of service would expect to receive a maximum of $622 under the structural-change option or $637 under the combination option, as compared to $724 under the current program. (All figures approximate based on 1985 pay scales rounded to the nearest $1.00.) The loss in initial retired pay would not only be significant but damaging to the rehabilitation of servicemembers and their families.

The Non Commissioned Officers Association of the USA urges the subcommittee to keep in mind the above unfavorable circumstance, as well as those probable adversities described in the Secretary of Defense report of 15 November 1985, when considering the options submitted for changes in the current military retirement program. With the large number of servicemembers in the lower grades expected to be on future retired roles, the adoption of either one of the two options will place an undue hardship on this group of dedicated and loyal men and women who will serve the nation in uniform.

The Association recommends the subcommittee to find both options unacceptable. Thank you.

Senator WILSON. This hearing is adjourned.

[Whereupon, at 3:52 p.m., the subcommittee adjourned, subject to the call of the Chair.]

PROPOSALS TO CHANGE MILITARY RETIREMENT

THURSDAY, DECEMBER 5, 1985

U.S. SENATE,
COMMITTEE ON ARMED SERVICES,
SUBCOMMITTEE ON MANPOWER AND PERSONNEL,
Washington, DC.

The subcommittee met in open session pursuant to notice, at 1:30 p.m., in room SR-232A, Senate Russell Office Building, Senator Pete Wilson (chairman) presiding.

Present: Senators Wilson, Thurmond, Exon, and Glenn.

Staff present: Patrick A. Tucker, counsel; David S. Lyles, professional staff member; Patricia L. Watson, research assistant; Mary J. Kampo, staff assistant.

Also present: Dale F. Gerry, assistant to Senator Cohen; Gregory B. Craig, assistant to Senator Kennedy; and Phillip P. Upschulte, assistant to Senator Glenn.

OPENING STATEMENT BY SENATOR PETE WILSON, CHAIRMAN

Senator WILSON. Good afternoon ladies and gentlemen. This hearing will come to order.

The subcommittee meets today to conduct a second hearing on proposals to alter the structure of the military retirement system. These hearings are occasioned by the action of the House and Senate conferees who inserted in the Defense authorization bill for fiscal year 1986, a requirement that the Department of Defense respond to specific proposals that would reduce the accrual account for retirement.

In our hearing yesterday, we heard testimony from representatives of the Secretary of Defense and from the Armed Services. Today we will receive testimony from representatives of the Congressional Budget Office and the General Accounting Office.

In addition, our first witness will be the junior Senator from Illinois, Hon. Paul Simon. Earlier this year Senator Simon, along with Senator Eagleton introduced S. 1150, the Uniform Services Retirement Act of 1985, which is pending before this subcommittee.

Senator Simon will be testifying about that bill which takes a somewhat different approach to military retirement than either of the two Department of Defense proposals pending before the subcommittee.

Before we hear from our witnesses today, I want to indicate for the subcommittee members that it is the intention of the Chair to

schedule a subcommittee meeting sometime next week for the purpose of marking up a bill on military retirement.

I do not mean by taking this action that I have yet determined the particular forum that will emerge as the markup. It is simply that it is encumbent upon us to take action either to provide for some change in the retirement law or to give relief to the Department of Defense from the financial crunch that has been imposed upon it by the action of the conferees and by the fact that we are now in the third month past the time that we had hoped to actually have from their proposals.

I emphasize that is not the fault of the Department of Defense. They were not, in fact, authorized to engage in the very work that has been required of them by the DOD authorization bill until such time as we had a bill. The failure of the House to enact or to act upon that legislation until much, much later than the conference itself, which was already late in the year, has occasioned the particular time frame in which we unfortunately find ourselves.

We have now reached the time, I think, to make decisions. We have certainly no shortage of information, although we necessarily look to the testimony that we will receive today from the Congressional Budget Office and from the General Accounting Office, and having read that testimony I think it is extremely valuable.

I am convinced by continuation of this debate year after year, I might say not at all parenthetically, that this is a climate of uncertainty which itself may be more hopeful to the morale of our servicemen and women than would any of the proposals that have been made to change military retirement.

Additionally, we will reemphasize we are in a difficult budgetary situation because by restricting the authority of the Secretary of Defense to expend funds for military retirement at the rate required under the existing entitlement structure.

We must take action. We simply cannot fail to act and let things drift. Our choices are essentially three: Make changes in the retirement law in the basic entitlement that will conform to the $2.9 billion cut in the accrual accounts imposed by the conferees; second, to give relief to the Department of Defense; and third, in the event of our failure to act at all, I think we will hear today from the General Accounting Office, the third opinion would be for the Department itself to very quickly engage in force reductions, end strength reductions, of a kind that we obviously did not intend and that we did not enjoin upon them.

We must either report a bill to alter the retirement entitlement structure or a bill which will return to the Secretary of Defense the authority to spend funds at the required rate.

Lacking that action, if we fail to return that authority, we are going to place the Secretary in a very unpleasant position, indeed. If we return that authority, there will still be the problem of the $2.9 billion which we have not now included in either the House or the Senate reported defense appropriation bills.

Quite simply, we must make some decisions and we must make them soon, and I propose that we make those decisions next week.

Now, turning to today's witnesses, our first witness is Hon. Paul Simon, U.S. Senator from Illinois. Then we will hear from Mr. Martin M. Ferber, the Associate Director from Manpower, Reserve

Affairs and Logistics, Group, National Security and International Affairs Division of the General Accounting Office.

Mr. Ferber will be followed by Robert F. Hale, the Assistant Director for the National Security Division of the Congressional Budget Office.

We will enter the formal statements of each of the witnesses into the record. I would ask that oral presentation for each of our witnesses be limited to approximately 15 minutes.

Senator Glenn, before turning to you for an opening statement, let me say that it is my intention, assuming that we may be joined by some of our colleagues, to have the same procedure that we followed yesterday with questioning in 10-minute rounds.

Now, it is my pleasure to invite for an opening statement the distinguished ranking member, Senator John Glenn.

Senator GLENN. Thank you, Mr. Chairman. My remarks will be short today; shorter than they were yesterday. I gave my views on a lot of things yesterday, as some of you know who were here at that time, because I feel very strongly about this.

I think to be put in the position of just arbitrarily having a committee tell us that we have to cut $2.9 billion out of pay, salary, allowances, and retirement pay, right off the top of our head, and we have to come up to that figure no matter what effect it will have on the military, on recruitment, and on combat capability, as I said yesterday, is about as dingaling as anything I have seen in the 11 years I have been around here. That is the way I feel about it.

By saying that, I do not say that we cannot make alterations in the retirement system for the Armed Forces. Perhaps they are in order. My mind is still open on that subject, not locked into either making changes or not making changes now.

I do object very much to a Senate procedure that just says, bang, without any hearing or anything, we have to come up with a $2.9 billion figure. I wish some of the people putting that in had had bravery enough to suggest that we do away with a weapons system or two and fight that one through all the political constituencies instead of always taking it out on the personnel.

That is the first thing that happens. We get in a bind on budgeting, and we are going to take it out on personnel. They can take it. They can take it, sure.

I just do not agree with that. I think this climate of uncertainty that the chairman properly mentioned is very real. I was thinking after the hearing yesterday, there is a little—the old thing of Kipling referring to the British services as Tommy this and Tommy that and throw him out, the lout, but he is the savior of his country when the guns begin to shout.

Well, we are in a "throw him out, the lout, throw the louts out" mode right at the present time because of some of our budget problems, apparently, and that overstates it. That does not mean to me that we cannot go ahead and make some changes in the retirement system.

If we can make changes and save some money and not do irreparable damage to the personnel of the armed services and to recruiting and retention, then fine, I am all for making them; but to just give a mandate to this committee that you have $2.9 billion to

come up with, and it comes out of the hides of the people in there without any other consideration than that, I disagree very strongly with that way of doing business.

The Department of Defense has reluctantly submitted a report, but today it is our particular pleasure to welcome our colleague, Senator Simon of the subcommittee, and we do appreciate your willingness to bring your ideas to us personally here and not just a written report, which happens sometimes when we all get too busy around here, and to allow us the opportunity to discuss and debate these things with you in person, Paul. We appreciate that.

I also want to note that the prepared statements submitted by Mr. Hale of CBO and Mr. Ferber of GAO were both excellent analyses of the Defense Department's retirement proposals. We appreciate those, and we will have questions for them after they have delivered their prepared statements.

Thank you, Mr. Chairman. I look forward to our witnesses' testimony.

Senator WILSON. Thank you, Senator Glenn.

Now, Senator Simon, welcome.

STATEMENT OF HON. PAUL SIMON, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator SIMON. Thank you very much, Mr. Chairman and Senator Glenn. I appreciate the opportunity to be here. My staff tells me this is the 10th time in recent years that there has been some attempt to grapple with this thing.

I think the problem that you mentioned, Senator Glenn, about being imposed with the $2.9 billion reduction, is just the beginning of what we are going to face in this area if we do not get hold of this thing.

Senator GLENN. You mean the overall budget?

Senator SIMON. Yes. As you look down the road at what is going to be happening in this military retirement area, I think we have to recognize that some changes are needed, and I am among those who believe we ought to pay people adequately.

I could not agree with what Senator Glenn has said, and if you will check my 11 years here on Capitol Hill, I have never voted against a pay increase for military personnel. We have to provide adequate compensation, but we also have to recognize that we are building some long-range, major economic problems.

The nature of the Armed Forces has changed a great deal. In 1948 when the retirement system was set up, the current retirement system, we had just over 100,000 retirees then. We now have just over 1.5 million retirees. The percentage of combat troops to support personnel was also higher in the 1950's and 1960's. Today, only 14 percent of the active duty force is combat.

Now, if we want to say of these 14 percent combat, that we want to have special retirement benefits or special pay, I think that makes some sense. For the other 86 percent who are involved in technical jobs, white-collar jobs and that sort of thing, I do not think it makes sense.

I think also, as you look at the long-range, financial picture, it makes a heck of a lot more sense to use special retention tools. I

happen to believe the No. 1 problem of the Armed Forces, as I am sure you have heard from time to time from various military personnel, is personnel; much more important right now than maintenance or weapons systems or anything else.

How do you attract and keep good quality people? Here, a variety of special bonuses, education benefits and other things could be used. Now, the question is where do we go?

I think we can make some changes, and I think my proposal is a sensible change that will result in a substantial savings and not do any damage at all.

Right now, 12 percent of the force makes it to that 20 years for retirement. The average age for those who retire for the 12 percent is 39 for enlistees and 42 for officers. Two-thirds of those receiving retirement pay right now are still working. Only about 15 percent are over 65.

My plan is relatively simple. It does two things. No. 1, it says anyone who enlists after January 1, 1986—and you can pick another date—by January 1, 1986, you have to serve 25 years rather than 20 years, and for anyone enlisted after that date, you would get the full cost-of-living increase, but it would not be compounded, so that at the end of the period if you retired you got $10,000 a year, and there was a 5-percent cost-of-living increase, you would get $10,500. Then, if there is another 5-percent increase the following year, you would get another $500, and then it would be calculated on the $10,000, on the base, rather than $10,500.

When the average retiree lives 34 years or more and you start compounding it, when you get to the out years you are talking about very, very substantial amounts. By going to 25 years for the minimum vesting period—that is 5 years less than the Grace Commission recommended—you, I think, will see no great damage in recruiting.

I certainly believe in the COLA, which is an extremely expensive item, I cannot believe anybody walks into a Navy recruiting station and says, well, when I retire is the COLA going to be compounded? I do not believe that. I do not believe that is going to hurt recruitment one iota.

Talking about savings, and you have a chart, the CBO says that starting in 1990 we would save $10.7 billion. The accrual savings for fiscal year 1986 would be $3.3 billion.

I had my staff check this twice, and you had your staff check this. I asked them, what are the savings over a 50-year period by just going to this modest change? The savings over a 50-year period are $867 billion.

Now, you know, that is a lot of money. That is by doing only two things: By not changing the retirement of anyone who is in the service right now one iota, but simply saying that those who come in after January 1 or whatever date you pick, after that you have to serve 25 years rather than 20. You will get your full cost of living, but it will not be compounded.

CBO projects—and I have no way of knowing how they project these things—they project that this retirement plan would reduce the enlisted career force by 7.8 percent and the officer career force by 4 percent; but that is assuming that there were no other subtractions made for any other bonuses for enlisting.

My assumption is that you could modify that, but even then it is not an unlivable kind of thing, even if their projections are correct. Military retirement pay is the second most expensive of all Federal entitlement programs funded exclusively from general tax revenues.

Medicaid is the more costly one. Medicaid covers more than 20 billion beneficiaries, over 13 times as many people. I am a veteran myself. I am proud to have served overseas in the Armed Forces, but I think we have to recognize that we have a serious problem.

I just came from a meeting with our colleague, Senator Gore, and he gave me three figures that were very interesting. You retire as a civilian just in general from a private pension plan, that private pension plan gives you upon retirement 20 percent of your average pay.

If you retire as a civil service worker with the Federal Government, right now it is 25 percent and with the new program it will be 22 percent.

You retire under the military, the average is 55 percent. The military retirement system has been a generous one, and I do not want to do anything that is going to harm a good enlistment program or keeping quality people in the Armed Forces.

I think we have to recognize we are facing something that is going to get so heavy that if we do not act, we are faced with unacceptable alternatives. The problem with the military retirement becoming so heavy is that we have no alternatives there.

If, for example, we have some incentive for pay or if we decide to build a new weapons system, we can cancel those things, but retirement is not something you can start canceling down the road.

I think now is the time to address this. I think we can do it and save huge amounts of money for the Federal Government. That is basically my message, Mr. Chairman and Senator Glenn.

[The prepared statement of Senator Paul Simon follows:]

PREPARED STATEMENT BY SENATOR PAUL SIMON

Thank you, Senator Wilson, for inviting me to testify before this committee on the subject of military retirement reform. I appreciate this opportunity to describe the bill I introduced earlier this year, "The Uniformed Services Retirement Act of 1985," and my amendment to the DOD Authorization Bill which I later withdrew from Senate consideration.

The military non-disability retirement system has been the subject of nine studies in the past ten years. DOD's new study, released last week, is now the tenth effort to come to grips with this system. Unfortunately, while the Defense Department complied with the instructions sent from the House-Senate conference managers, its position remains unchanged: Secretary Weinberger has indicated in his cover letter that he and senior military officers are steadfastly opposed to any changes in the current system.

I am convinced that this attitude flies in the face of current and expected realities. Opposing any changes now guarantees a future stalemate, a logjam that will become more difficult to get out of and grow more costly the longer we delay.

Retirement pay is one part of the basic compensation package we offer to maintain a high-quality military force. It is an important part of the package, but it is not the only part. Consider some of the pay and tax advantages given to active duty personnel:

Rent-free government housing or cash allowances, exempt from state and federal taxes;

Free meals, or cash allowances exempt from state and federal income tax;

They do not pay into their retirement plan;

Unlimited free medical care and, in many cases, free health care for dependents;

A large percentage do not pay state income tax on any part of their basic military pay;

Military take-home pay, in most categories, is better than its civil service counterpart, and in addition the military retirement plan generates almost double the lifetime earnings of the general schedule civil service personnel with equivalent years served.

And finally, the military retirement plan is widely considered to be superior to almost every other country, especially in terms of real lifetime earnings.

I do not raise these points to make the case that the military is over-compensated, or that it is being treated extravagantly. On the contrary, I want a fair and equitable system that meets the budgetary realities of the 1980s. And I support these benefits offered to our troops, because military service is vital, it is unique in many ways, and these parts of the package help in recruiting and retaining personnel. I have supported every military personnel pay increase during my years in Congress.

But the fighting force has changed dramatically since 1948, when the current retirement system was established. Then, there were just over 100,000 retirees on the rolls. Today, there are over 1.5 million. The percentage of combat troops to support personnel was higher in the 1950s and 1960s than it is today. Today only 14 percent of the active duty force is combat. Perhaps some kind of formula built into the retirement pay system should favor those who put their lives on the line. But I am not sure why we ought to encourage the remaining 86 percent, who mostly perform white-collar and technical jobs, to leave the service at age 42. The current system does exactly that.

It also makes sense that we consider special retention tools that have already been introduced to some degree, such as special skills pay, hazardous duty pay, flight bonuses, and sea pay. Given the different skills required of today's military, and given the stress on high-technology, we ought to move to a system that offers higher basic pay to people with special skills especially sought by the military. And a top stress should be educational benefits, which entitles a recruit with four years of service to $26,000 in benefits.

THE SIMON PLAN

Today only 12 percent of the force makes it to the minimum vesting period of 20 years of service. The average age for this 12 percent is 39 for enlistees, 42 for officers. In large part, this is due to the retirement plan, which encourages military members to retire early and market themselves in the private sector. Two-thirds of those receiving retirement pay are still working; in fact, only about 15 percent are 65 or older.

My plan is straightforward: members enlisting after January 1, 1986, would be required to serve a minimum of 25 years of active duty to receive 50 percent of base pay and 30 years to receive 60 percent. I would increase the minimum period by five years, even though the Grace Commission recommended that the minimum vesting period be 30 years. My figures are reached by reducing the multiplier (final basic pay x years of service) from 2.5 percent to 2 percent. Finally, I would not compound the COLA each year. In this way, we would save at least $10.7 billion per year after 1990 on accrual retirement pay. If you assume an annual inflation rate of 5 percent, the current plan will cost the taxpayers $867.8 billion more than my plan out to the year 2041. That is why I support doing away with compounding the COLA.

The effect in fiscal year 1986, according to the Congressional Budget Office, would be a retirement accrual reduction of $3.3 billion. This is only $400 million more than the amount targeted for reduction by Congress. When the "steady state" plan is fully in place, CBO projects that this retirement plan would reduce the enlisted career force by 7.8 percent, and the officer career force by 4 percent. I do not find these figures too significant, when you consider that cheaper retention tools can be offered in place of retirement pay, and when you consider that projections of future force requirements are highly variable and subjective.

Military retirement pay is the second most expensive of all federal entitlement programs funded exclusively from general tax revenues. Only Medicaid is more expensive. Yet Medicaid covers more than 20 million beneficiaries, or over 13 times as many people as now get military retirement pay.

My plan provides for a long-term, fair solution. I am a veteran myself, and I want to see a good, sound, healthy military. But revision of the current plan is essential. I am not aware of any reputable study, for example, that says you must compound the COLA in order to attract recruits or maintain retention. I just can't imagine that the average young recruit is calculating future retirement pay as the final arbiter of whether he or she enters the service. If he or she is that ambitious, the indi-

vidual will also consider the many tax-free fringe benefits and educational opportunities.

The men and women who defend the country are dedicated and decent people. They deserve a fair and equitable retirement plan, along with the other elements of the basic compensation package that offset the rigors of a military career. My proposal gives prospective recruits a good and fair plan, one that we can afford, without breaking our commitment to those already in the Armed Forces.

Thank you.

EFFECTS OF SIMON MILITARY RETIREMENT PLAN [1]

[In fiscal year 1986 dollars]

[Revised—April 29, 1985]

	Fiscal year					
	1986	1987	1988	1989	1990	Steady state
Formula revisions only, Savings in MilPers Cost:						
Retirement as outlays (Chg in deficit)		−10	−25	−45	−60	
Retirement as accrual	410	1,170	1,915	2,585	3,120	9,400
Manpower Losses:						
Enlisted Career Force:						
Number						65,291
Percent						6.8
Officer Career Force:						
Number						5,907
Percent						2.9
Full Simon Plan [2], Savings in MilPers Cost:						
Retirement as outlays (Chg in deficit)	−125	−40	45	110	180	
Retirement as accrual	3,300	4,150	4,900	5,600	6,100	10,700
Manpower Losses:						
Enlisted Career Force:						
Number						74,616
Percent						7.8
Officer Career Force:						
Number						8,114
Percent						4.0

[1] Vesting at 25 YOS; 2.0 percent multipliers to 30 YOS; COLAs paid only on amount of initial annuity.
[2] COLA provisions stimulated by 75 percent COLA.

Senator WILSON. Thank you very much, Senator Simon. We are grateful to you for your keen interest and the work that you and your staff have done in this area and for your being here today to present your legislation.

As you pointed out, CBO estimates that your bill will result in a loss of personnel, specifically what they have predicted is a loss of some 83,000 career personnel.

First, I do not know whether your estimate agrees with theirs but, second, if it does, do you believe that we can afford our career force reduced by that many personnel? And if you do not, then how would you avoid it and still implement your legislation?

Senator SIMON. First of all, let us just assume their figures are correct, and I do not know that anyone knows for sure what is correct or what is not.

First, I assume that some slight loss we can take. Second, under my proposal, even this fiscal year with a limited impact, you are talking about $3.3 billion in accrual savings.

Your mandate is for $2.9 billion. That would give you $400 million that you could put out for bonuses, for other things; educational benefits. That is a lot of money, and because the savings for this

fiscal year are very small as compared to future years, it would not take very many years at all, and you are saving many billions of dollars.

I think there are ways to compensate for that enlistment problem.

Senator WILSON. Your approach to yearly adjustments is a unique one. How would the formula that you are proposing provide protection to elderly retirees during an extended period of high inflation?

Senator SIMON. The answer is that you give them the full cost of living increase. I am not suggesting that anyone does not get the full cost of living increase, but do not compound it.

The problem of compounding is not a great problem on Social Security. It is a problem. It is a problem on Federal civil service and others, but when you get into the military area where the average retiree is on the rolls 34 years right now and that is probably going to be extended as our life span goes up.

When you start compounding for 34 years, then you are starting to build some huge, huge numbers, but my proposal is that we continue to give the full cost of living adjustment, as virtually no private pension plan does.

It is still a very generous program, and again I cannot believe that the COLA, the compounding of the COLA, is going to reduce enlistments one bit. I cannot believe that anybody walks into—I cannot believe that when John Glenn enlisted in the Marines, if I may pick on my good friend and colleague, I cannot believe when he enlisted in the Marines he had very many questions about whether they were going to compound the COLA after he retired.

Senator GLENN. That was the first thing I asked about. [Laughter.]

That and Pearl Harbor convinced me.

Senator WILSON. I think the question is not what those people standing in line on Monday at Pearl Harbor were thinking, but I think what we would ask now in a time of peace, but a time when we are required to be concerned with things like combat readiness, whether or not the kind of staff NCO's that we are depending on as our teaching cadre, as our instructors, as the real backbone of every service, whether or not when they come to the 8th year or the 12th year, that is of concern to them.

I believe we are having a semantic problem. My understanding is you say you give a full cost of living.

Senator SIMON. A full cost of living. So let us just say you retire and you are getting $10,000 a year in retirement, and then there is a 5-percent cost of living increase, so you get $10,500.

Let us say there is a 5-percent cost of living increase the second year. Instead of calculating it on the $10,500 as you do right now, you go back to the $10,000 base, so that you give a full cost of living increase but it would be calculated on the base.

Senator WILSON. I understand now what you are saying. That is what I thought you had in mind. What you are proposing, which you are well aware of I guess, is a very substantial reduction over a period of time for those retirees.

Senator SIMON. Over a period of time there would be some reduction, but there is no comparable system where you are having com-

pounding over a period of years. You are talking about huge, huge——

Senator WILSON. What about civil service?

Senator SIMON. Civil service and Social Security, there is a compounding, but the average retiree on Social Security, as I recall, is on the system for about, what, 9 years, something like that, so you do not get these huge numbers on the compounding.

That is the problem, and I do not think it will hurt recruiting one bit. It protects people, and you get in the—you see what is happening on that chart on those out years. You are talking about huge, huge numbers.

I have to believe that tackling this makes some sense. Incidentally, even on Social Security and the others, back when we were talking about how we might save money in some of the other retirement programs, senior citizens groups said they would much sooner have a noncompounding at the cost of living rather than some of the other things that were being suggested at that time.

Senator WILSON. One of the problems that your legislation poses for at least a couple of the members of the subcommittee, I think I can speak for them, is that there has been a commitment made that there would be nothing in the way of retroactive——

Senator SIMON. I do not suggest that. Let me make clear I am not suggesting that anyone who is in the service right now get any change whatsoever, no change in retirement. Anyone who is in right now gets to retire at 20——

Senator WILSON. Your proposal for yearly adjustment does not apply to current retirees?

Senator SIMON. That is correct. It applies only to those who enlist, my bill says January 1, 1986, but I think if you—and because you face this problem that John Glenn just talked about of this $2.9 billion, if you were to say that anyone who enlists after January 1, 1986 they have to, No. 1, serve 25 years, No. 2, they get the full cost of living but it is not compounded, you save $3.3 billion.

You save $400 million more than that target that you have to meet, and you do not adversely affect anyone in the service right now.

Senator WILSON. Apparently we had gotten that earlier version.

Senator SIMON. There was an earlier version where I did have a somewhat different approach.

Senator WILSON. It has been estimated that the full effect of your bill would be to reduce the total value of lifetime military benefits by almost 60 percent.

Senator SIMON. I do not know who gave you that estimate. I would seriously question that.

Senator WILSON. It is the Congressional Budget Office.

Senator SIMON. Well, they can address that, but I cannot believe the accuracy of that figure.

Senator WILSON. All right. I think we have a basic problem that does need to be resolved, because their estimate is 60 percent, and they have reached that, I gather, using the same methodology that they applied to the two Department of Defense proposals.

I think that is how they have come to the conclusion that the bill would produce the loss of 83,000 current personnel, so I think that does need to be resolved. I do not know what methodology you applied.

I did hear in your statement an estimate by you what the impact would be in terms of retention.

Senator SIMON. I accept their figures on the retention. Their retention figures assume that there are no changes made at all in the way of bonuses and other things, and my point is simply that if you accept their retention figures and if you were to aim for the $2.9 billion that your subcommittee has been mandated, that you would have under this program $400 million in additional enlistment incentives to provide.

Four hundred million dollars is a lot of money for enlistment incentives. You can provide educational benefits and a lot of other things.

Senator WILSON. I take your point, but let me, as my final question because I gather my 10 minutes are just about up, let me just ask you this.

One of the cardinal points of your legislation would be to change the vesting date from 20 to 25 years.

Senator SIMON. That is correct.

Senator WILSON. Yesterday the Deputy Assistant Secretary of Defense for Manpower and all of the personnel chiefs from the services, for each of the four services and the Coast Guard, appeared before us.

To the man, they each testified that the most important feature of the present retirement system is the ability to retire after 20 years of service.

Specifically, they were concerned that because retirement does not come to focus in either a first enlistment or even a first reenlistment in many cases, it in their judgment becomes the major incentive at about the 8th year of service on to the 12th year of service, at that critical time when we have young sergeants, staff sergeants deciding whether or not they are going to go with the full 20 years.

Their testimony was that when you have been in for 8 years or even for 12 years, that 20 years is within grasp but if it gets too far away then these other things like the attractiveness of the civilian world, higher pay for some critical classifications is simply going to make it too difficult to resist the temptation.

With a 25-year retirement, what would your response be to them when they say that it will lose all those people that we are trying to keep, the best of these career, potentially career staff NCO's?

Senator SIMON. My response to them is they have figured out probably the most expensive way possible to answer that problem. You have right now only 12 percent of the personnel who enlist who stay for the 20 years.

If that is the question, then in those critical skills let us put some extra pay, some extra bonuses out there that do not apply on retirement. Let us put them out there for these people, but let us not find the most expensive way possible to answer the problem.

That is what they have come up with. It is simple. It works right now. It is also the most expensive possible answer. I think we can come up with less expensive answers.

Senator WILSON. My time is up. Senator Glenn?

Senator GLENN. Thank you, Mr. Chairman.

The Navy admiral yesterday ran through a career pattern a lot of people follow, which I thought was pretty valid, just from my own experience and being around the military a long time.

A young person gets in. It is sort of a lark. I will sign up; I will do a hitch; I will get some benefits here, whatever. At the end of that time period he probably has liked it, and by the time he has gotten enough seniority after a hitch, maybe he has begun to look forward to being an NCO, and that is no carrot there, and that is fine.

So he stays in the second time, and then all at once he has gotten married, and then he has some other responsibility, so he does not quite want to make a change. That is about the time the 20 year thing really is what keeps people in instead of getting them out, was what he said.

I do not think he is entirely wrong on that, either, because by that time they are maybe at the 12- or 13-year period, they can tell him, hey, look, one more hitch here and we want to use you, now. You are an NCO, you are valuable, you are all these things to us. You have experience, you are a leader of troops, you are a squad commander, you are a platoon commander or whatever.

The thought of a 20 year thing where, OK, stay in. By the time you get to that point—you are going to be about 40, maybe 42. You still can have another career, but we need you for another 6 or 7 and get you through that 20, where if it was 25 I am sure that the admiral—I did not ask him specifically that, but I am sure that is another quantum leap ahead here in what you could expect them to sign up for.

That is what came out in some of our testimony yesterday, and I think the admiral's analysis of that is probably pretty good.

Let me correct some figures here, though, let's take just a moment on some things you said. You and Senator Gore talked about——

Senator WILSON. May I just interject one point, there, because I think we are trying to pursue the same thing.

One of the points they made was that—and when I made reference to the attractiveness of the civilian world, apparently a very great concern that a lot of these young men have is that they will be able to pursue a second career in 20 years, but 5 years later their attractiveness in the civilian marketplace has diminished.

Now, I do not know whether your analysis has actually pursued that, tried to quantify it, but what I think is a very real concern to them as a result of the fact that it is a stated concern to a number of the people whom they are in fact losing.

Senator SIMON. Again, my answer would be that we have probably the most expensive way of trying to keep those key personnel, and we ought to determine where these key personnel, if we need to pay them more, if we need additional bonuses, whatever.

It is a lot cheaper to do whatever is necessary to pull these people in for an additional 5 years than to have——

Senator WILSON. We are already spending $1 billion on special reenlistment bonuses.

Senator SIMON. I understand, but when you look at these figures down the road, for example, you say we are already spending $1

billion. By 1990 which is not very far off, 1990 according to the CBO, my plan saves $10.7 billion, so you add another billion.

You are still saving $8.7 billion a year. You know, there have to be less expensive ways of doing it than we are doing it right now.

Senator GLENN. You mentioned a couple of times the educational benefits as incentives, and I am not sure I agree with you completely on that because educational benefits tend to get people out, not in.

They get their qualifications for educational benefits and then they want to get out. They are not going to get the educational benefits and look forward to that and then stay in until 20 until they use it. By that time they are going back to school in their mid-40's and that is the last thing most people want to do in their mid-40's is go back to school.

I think educational benefits, per se, are an attraction going for someone who is planning one hitch, get the benefits, get out, and that is fine. As far as retention, it works just the opposite with the NCO's and the people a little futher up the chain that are being attracted by a 20-year retirement.

Senator SIMON. Can I agree and disagree with you?

Senator GLENN. Absolutely. I could say no, but I will not.

Senator SIMON. There is no question that people who enlist for educational benefits plan to do that, but what it does is to attract some people into the service who otherwise would not go in, and some of those then stay.

One of the problems that we have is to attract the quality of personnel into the service that we need to attract, and there is no question the educational benefits help.

Senator GLENN. Let me correct some of the figures that we had. These were in testimony yesterday here, and the figure as a percent of total compensation that you talked about a while ago that you and Senator Gore discussed, referred to as the normal cost percentage figure.

In other words, it is the cost that goes into retirement as compared to the percentage of what they are being paid during working years, and for the present in the private sector pension, it is about a 20-percent figure.

Civil service is about 25 percent now if you figure that on total compensation. Now, in the Senate, there is a Senate-passed bill on civil service that would cut that back to about 21.9 percent, but it is running at about 25 percent now, I believe.

The 50-percent figure that you mentioned for the military, though, is figured only on basic pay which is only part of the compensation package. Now, if you take the total compensation package, people who are going on active duty, and take the normal cost percentage figure on that based on total compensation, it comes down to 29 percent right now, which is beginning to get comparable there, of course.

If we go through this $2.9 billion, it would be 24 percent. It is quite comparable there compared to the 22 percent if the Senate bill goes through. If the Senate bill is not passed by the House and civil service remains at the 25 percent, and we make the $2.9 billion cut, it would actually put the military below civil service as far

as total compensation goes, so the figures are not quite as desperate there as you indicate.

Senator SIMON. You are correct. Those figures are calculated on the base pay, and so there is that discrepancy.

Senator GLENN. Mr. Chairman, I wonder if I might ask the CBO witness to comment on this 60-percent figure you have while Senator Simon is in the room here, and we could maybe get both your views on this.

Would it be possible to ask him, because he took exception on their figures, I think it would be good while he is here, because I am sure he has other things he wants to get on to.

When his testimony is done, maybe we could have them see what the difference is.

Mr. HALE. I think the 60-percent figure is determined by looking at the reduction in accrual costs, which would be about $10 billion out of $18 billion, roughly 60 percent. That would approximate changes in lifetime earnings on average, though we did not actually calculate lifetime earnings. Those are going to vary according to exactly when the person retires, and so forth. Sixty percent is about right, then for the accrual cost reduction.

Senator SIMON. I cannot respond immediately. It strikes me just offhand as simply not compounding would not result in a 60-percent reduction, but it may be that that is correct.

Senator WILSON. I will let him answer, but I think that is only about 25 percent.

Mr. HALE. All the elements of the plan together amounted to a 60-percent reduction. The decrease in the multiplier from two and a half to two, going from 20 to 25 years at retirement, and the simple compounding provision; everything together.

Senator GLENN. The COLA itself, the COLA effect was the 25 percent, correct?

Mr. HALE. It would be on that order. As I recall, by the end of the career the COLA saving was 25 percent. It is on the order of a 20- to 25-percent reduction, and that is in real terms. The effects of the Simon COLA proposal are substantial because we are comparing compounded price increases under current law to simple price increases under the Simon plan. Over a long period the difference would be substantial.

Senator SIMON. The 25-percent figure is more in line with—but it is still a very generous system, and we would still be providing full cost of living increases. It is simply not compounding it in those out years.

Senator GLENN. I agree that the compounding and the fact that it goes on for a little longer period of time or a considerable longer period of time is an important factor there, but if the same principle is to apply in other Government retirement programs or Social Security, would it mean that you would favor applying this type proposal COLA for military retirement?

What you are proposing there would you also propose to apply that to other Federal retirement programs such as civil service or Social Security?

Senator SIMON. Well, I have suggested on some cost of living things that I have been involved in in the education and labor committee, but it is not as great a problem in any of these other pro-

grams, say black lung or Social Security, because of the number of years.

Senator GLENN. The figures are bigger here, but I am talking about fairness. Is it fair to ask people to take a COLA cut in one area if you are not going to ask them to take a COLA cut in another area?

I know it is a bigger factor here, but is it fair to ask them to take that cut?

Senator SIMON. Well, the one difference here is, for example, Social Security is a self-financed system. Military retirement is not a self-financed system, and so I think in a sense you are equating apples and oranges here.

Let me just say if we were faced with a situation in Social Security where we had to come up with the savings of $10 billion or otherwise we face major problems, I would favor taking a look at that rather than some other changes that people have talked about.

Senator GLENN. How about civil service retirement? That is not a self-financed system, though.

Senator SIMON. Well, in part it is. It is partially. Civil service employees pay in.

Senator WILSON. The point you are making is this is noncontributory?

Senator SIMON. That is correct.

Senator WILSON. I would not call either of them self-financed.

Senator SIMON. The answer is if you are going to make changes, this is a change that is much more equitable than any of the other changes that are coming along.

Let me just add, if we do not make changes now—and I know that a lot of the groups do not want to see any changes, and I read Secretary Weinburger's statement—if we do not make sensible changes now, just as sure as we are sitting here somebody is going to come along with a meat axe 5 years from now or 10 years from now, because the thing is going to be so heavy, and then we are really going to do an injustice to people.

Senator GLENN. My time is up, Mr. Chairman.

Senator WILSON. Go ahead.

Senator GLENN. The 60 percent thing we have covered, would you propose—we mentioned other increases or other elements of military compensation such as bonuses, continuation pay, to offset what would be a very substantial reduction, up to 60 percent according to CBO, in the value of military retirement as a retention incentive.

Do you have any other ideas? The education you mentioned a couple of times, and I commented on that.

Are there other ideas as to what the compensation might be that would make up for this, and if there are, the things we are suggesting, how expensive are those? Is that going to be as expensive as the 20-year retirement?

Senator SIMON. Obviously, I think you can find things that are substantially less expensive. I mentioned that 3 years from now or 4 years from now, the savings as projected by CBO are $10.7 billion.

Well, if you took the $1 billion in bonuses you provide right now and just doubled that to $2 billion, you are talking about a very substantial increase in bonuses. You would still save $8.7 billion, and I think those bonuses ought to be targeted specifically to areas of great need, to those NCO's you are talking about; or if we need dentists, target it for dentists; or whatever the specific needs may be.

Senator GLENN. Back to the 20—the change from 20 to 25 years. Particularly in the services, the Army, the Marine Corps, where a high percentage of the people involved are in very physically demanding jobs, you are talking about having people perform those jobs up into the mid- to late-40's where now probably they are, at best, the early 40's, 40 to 45, you would be moving this up, say, 45 to 50.

You are asking NCO's and the senior people to keep that fit if they are going to stay in. I do not know whether just age is going to be a factor or not.

Do you have any feelings on that?

Senator SIMON. Yes, I think the evidence is pretty overwhelming that these physically demanding jobs are declining in the services. I was in the service in the early 50's. It is dramatically different today, both in terms of numbers in combat and other things, so I really do not think that would be a major problem.

Senator GLENN. How would you take care of that, though, because there are physically demanding jobs. If you are out with a platoon in the field and you are in combat, that is about as physically demanding as anything I know of.

How would you take care of that, because you are setting up for averages and you are setting up for a great number of people. You are setting up for millions of people in these areas here. I do not think we could just dismiss it and say it would not be a problem. I think it probably would be.

Senator SIMON. Let me just give you an analogy, the Illinois State Police. It is a physically demanding job, very often. You retire at the average age of 55.

In the Armed Forces you retire at the age of 42 if you are an officer, 39 if you are an enlisted man. Only 12 percent of those who are in go up to that point of retirement, so it seems you have 88 percent who do not go to that point of retirement who can do these physically demanding things.

I can remember—and I hate to say you, too, can remember—when George Blanda was playing——

Senator WILSON. Who?

Senator SIMON [continuing]. Was playing football at the age of 50. At the age of 39 a lot of people are in pretty good shape. The best tennis player in the U.S. Senate is Howard Metzenbaum, and he is—I do not know, he is well beyond 39.

Senator GLENN. I think that is certainly something to consider here. It is not just a matter of up and out and providing new blood coming in all the time. It is a physically demanding job in the armed services, and you are absolutely correct in that our percentage of jobs that are that physically demanding are not the same as they were in the days of the revolutionary war when 99 percent of

your force was out in forced marches down the road for 20 miles a day or whatever they did back in those days.

Fortunately, our technology has moved us into the field where we now have a greater number of our people involved in technically demanding jobs as opposed to physically demanding jobs, but there still is that requirement for a large number of people.

I would question whether it is clear down to 12 percent or not. Maybe it is; I have not seen recent figures on that. We do have a greater number of people required to be in the pipeline and technical support for those few people who are out there getting shot at and shooting in return, and so that is true.

You are still trying to set up a force that has a force in there where you can call on far greater numbers of people for very physically demanding, long-term work if that is required.

Senator SIMON. The 12-percent figure is those who serve the full 20 years. Fourteen percent is the figure for those——

Senator GLENN. The ratio of supply to people on the front line was 8 to 1. It was 6 to 1, 15 or 20 years ago. Somebody correct me if I am wrong on that, but I think it was like 8 to 1; somebody in the pipeline or headquarters or a battalion, whatever it is, as opposed to that guy getting shot it.

I think it is supposed to be around 8 to 1, so your figures are not too far off even in that regard.

The DOD proposals could save or would save $2.9 billion in retirement accrual costs for fiscal 1986. What is the comparable savings figure for your proposal? Is it 50 percent of the total request of $18.2 billion or roughly $10 billion?

Senator SIMON. I do not follow the last part of the question, but the savings on my bill for fiscal year 1986 is $3.3 billion, so $400 million above the mandate of the subcommittee.

Senator GLENN. Mr. Hale?

Mr. HALE. We have a difference in accounting procedures here. The numbers that we initially gave Senator Simon preceded the Congress specification that we were to use the accounting procedures currently in effect.

As I say in my statement, our estimates for the DOD proposals assume those current accounting procedures and so assume immediate implementation, no grandfathering. If we did that with Senator Simon's proposal, it would immediately save $10.7 billion or thereabouts assuming everybody from the first day of 1986 was under the proposal on a comparable basis to the $2.9 billion.

Senator WILSON. You mean with no grandfathering?

Mr. HALE. No grandfathering is assumed in the $2.9 billion or in the $10.7 billion. I know it is confusing, but what the Congress said to DOD is, "use the accounting methods that you are using in fiscal year 1986", and they implicitly assumed that nobody was grandfathered. The $2.9 assumes that.

Senator WILSON. What was the figure that you came up with?

Mr. HALE. The $2.9 billion target essentially assumes everybody is immediately under the new system.

Senator GLENN. Let me ask, rather than my relaying, Mr. Lyles on the staff, here, would you ask your question here on the amount so that we can get this on the record.

Mr. LYLES. Mr. Hale, the $2.9 billion savings figure in the DOD proposal, what is the comparable figure in Senator Simon's proposal?

Mr. HALE. About $10 billion.

Mr. LYLES. About $10 billion, and that assumes that everybody was grandfathered? Those are savings in the retirement accrual costs, in other words?

Mr. HALE. Right. You look thoroughly confused, and I do not blame you. The accounting procedures that DOD is now using, which the Congress said to use in assessing all the plans where you set up the target, says do the procedure as if everybody was under the same retirement system as are new entrants.

In 1986, assuming that you passed the new plan, say Senator Simon's, you would immediately assume under these accounting procedures that everybody was covered under it, even though it was grandfathered. That would give you savings of about $10 billion.

Senator GLENN. Would the Simon proposal then cut basically three times what DOD has proposed?

Mr. HALE. Roughly.

Senator GLENN. As far as the attractiveness of 20 years, I would only comment that the Army is advertising now a place to start. I see that on television all the time. In other words, they try to get people in with the idea that it is a place to start and then get out, and I wonder whether we are not going to get more out than we want if we extend the 20 year retirement?

Senator SIMON. I guess the real problem that the Armed Forces faces—well, they have all kinds of problems, obviously, but the major personnel problem is to get the quality people in. Once you get them in, they are going to be people like John Glenn. When you went in, you probably did not plan to make a career out of the Marines.

Senator GLENN. Right, that is true.

Senator SIMON. I think there are a lot of people like that.

Senator GLENN. Thank you, Mr. Chairman.

Senator WILSON. Thank you, Senator Glenn. Thank you Senator Simon.

Senator SIMON. I thank you both.

Senator WILSON. Mr. Ferber, do you want to step up, and you can stay right there, Mr. Hale.

Go ahead, Mr. Ferber, you can begin.

STATEMENT OF MARTIN M. FERBER, ASSOCIATE DIRECTOR, MANPOWER, RESERVE AFFAIRS AND LOGISTICS GROUP, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. FERBER. Mr. Chairman, Senator Glenn. I am pleased to provide the views of the U.S. General Accounting Office on military retirement reform issues contained in the fiscal year 1986 Defense Authorization Act.

This act reduced the amount of funds that could be obligated from the military basic pay and the retirement accrual accounts, and required the Department of Defense to submit legislative pro-

posals to reform the military retirement system to meet this reduced obligational authority.

On November 21, DOD submitted its proposals and its views of their potential impact on retention.

You asked for our comments on DOD's proposals; specifically the accuracy of the estimated accrual savings which would result. DOD's estimate of the impact on retention; and the potential funding deficiency arising from delays in enacting legislation.

Mr. Chairman, I have some background information that I will skip except to highlight two points. First, to add some details on percentages, if enacted, DOD's proposals would reduce the accrual from 34 percent of regular military compensation to 29.6 percent.

This is still larger than the current 27.9 percent for the Federal civil service and the 22 percent that some changes being considered by the Congress would result in.

I believe the 25 percent for civil service is a figure from an OPM consultant. OPM's official figure is 27.9, compared to the 29.6 for the change in DOD's.

Second, as opposed to the major structural changes recommended in prior studies on military reform, DOD's current legislative proposals require only minor modifications, leaving the basic structure of the current system unchanged.

DOD'S ACTUARIAL ANALYSIS

The first area you asked us to address was the actuarial analysis DOD used to estimate the accrual savings of its proposal. Our objective was to determine whether DOD's analysis was done in accordance with accepted actuarial practice.

Our review consisted of examining an audit recently done by an actuary consulting firm to the DOD's Board of Actuaries, analyzing evidence gathered during an actuarial audit we conducted in 1982, and discussions with DOD's Chief Actuary.

Based on our review, we conlude that DOD used the methodology and assumptions approved by the Board of Actuaries as required by law to determine that the proposals would produce the required level of savings in the accrual charges.

DOD'S ESTIMATES OF RETENTION EFFECTS

The second area you asked us to address was the methodology DOD used to evaluate retention effects. Unlike assessing the actuarial analysis, evaluating the impact of the proposed changes on retention is a very inexact science.

My objective today is to provide some perspective on DOD's assessments. It is DOD's assessment that the retirement changes would have severe consequences and result in a loss of about 41,000 service members who would otherwise have remained in the military. These 41,000 are currently under the high-3 years system of retirement.

UNCERTAINTY INVOLVED IN RETENTION ESTIMATES

The consequences, however, of the changes seen by DOD have to be analyzed within the context of the uncertainty involved in eval-

uating the current change that will not have an impact for many years.

At different points in their careers, military members are most influenced by different factors in making career decisions to include staying in or leaving the military. For example, a DOD report submitted to the House Armed Services Committee last year concluded that monetary variables such as pay, benefits and civilian employment opportunities were clearly powerful predictors of first-term reenlistment.

Variables such as assignment location, quality of life, and job conditions were also important, especially after the first term.

Retention analyses and survey data show that the prospect of retiring after 20 years of service become very important only after 8 to 10 years. It is not just the amount of retirement pay that encourages retention, but also the all-or-nothing aspect of the 20 year retirement system, and to a lesser extent the other retirement benefits that continue.

It will, therefore, be 8 to 10 years from a change today before any real impact would become evident. Even then, the impact may be indistinguishable from the effects of other factors which might change in the meantime.

For example, DOD points out that the adverse effects of retention of the 1980 change to the high-3 years of pay were likely mitigated by pay raises and other compensation initiatives such as the variable housing allowance.

Finally, we are talking about a change based on today's force structure and projecting it 8, 10, 20 or more years in the future when no one knows what changes in force structure may be needed to respond to threats to our national security.

SPECIFIC COMMENTS ON RETENTION ESTIMATES

With these general points in mind, I have some specific comments on DOD's analysis of projected impact. My comments will cover four points: One, some positive aspects of a military career; two, the method used to assess retention effects; three, the sensitivity of the method to changes in assumptions; and four, some actions that may be necessary if retention does pose a problem.

OFFSETTING RETIREMENT INCOME REDUCTIONS

The positive aspects of military life may help offset any loss of retirement income for those who are considering a military career. DOD appropriately points out that a military career requires an acceptance of a highly disciplined life and the abridgement of some individual freedoms.

Commonly referred to as the "x" factor of military life, it is this very factor that attracts some to a military career. Other positive aspects of military life include job security and various benefits such as free health care.

In addition to also being motivated by patriotism, many military members may view their compensation, even with changes in retirement, as competitive with what they might receive outside the military.

While the proposed changes will reduce retirement pay, it should be noted that the retired service member continues to receive other benefits, such as commissary and retail shopping privileges and free medical care for themselves and their families.

Also, at 20-year retirement, the service member is provided a financial base from which to start a second career. In its report, DOD raises what it terms to be a basic question. If military retirement benefits are too great or too lucrative, as some have claimed, why do so few remain for a career?

Part of the answer seems to us to be given the DOD's enlistment slogan, "It's a great place to start." Many young people are joining the military to, one, learn a technical skill or trade; two, to take advantage of the new GI bill and the Army college fund which can provide over $25,000 toward college; three, start a job when one in the private sector might not be available or as attractive; and four, serve their country.

METHOD USED TO ESTIMATE RETENTION EFFECTS

The Congress directed that DOD use the methodology employed by the fifth quadrennial review of military compensation in evaluationg the impact of its proposals. A key part of the QRMC methodology was an econometric model. We think it is important to understand what this model can and cannot do.

The model considers only the effect of monetary factors, including the effect of deferred compensation in the form of a retirement annuity. It cannot assess the effect of such other factors as the loss of individual freedom, the propensity to serve in the military, the desirable or undesirable aspects of frequent moves or overseas assignments, and the quality of military leadership.

As a result, the predictions made by the model may not come to pass. The model focuses on the future civilian and military income that an individual service member may be comparing when deciding to stay in or leave the service. The income differences are then related to the historical retention rates in order to estimate what future retention rates would be based on changes in the retirement annuity.

Stated another way, the model presumes that individuals considering whether or not to reenlist after the first term evaluate the potential income differences that would exist each year over their lifetimes.

MODEL SENSITIVITY

The model used is very sensitive to changes in the variables it evaluates. In its report, the DOD states that, compared with analysis done by the Army, its projected retention impact are conservative. We would point out that making different assumptions about these variables could result in significantly different projected impacts.

For example, altering two key variables that deal with how military members value future income and respond to changes in income significantly reduces the model's prediction of retention losses.

Our analysis shows that as many as 12,600 more enlisted personnel in the 11 to 20 years of service group might remain in the service than DOD's analysis indicates. In the 21- to 30-year group, as many as 1,700 more might remain. I might add that these figures are 41 percent and 63 percent less than DOD's.

The bottom line is that there is significant uncertainty concerning the specific economic and behavioral assumptions that ought to be employed in applying an econometric model to the analysis of policy options such as the changes in retirement system.

Under certain reasonable assumptions, the retention impacts could be significantly smaller than those predicted by DOD. Conversely, under other assumptions impacts could be greater. Policymakers should be aware of this range of uncertainty.

IF RETENTION BECOMES A PROBLEM

What if retention does pose a problem? Then there are actions that can be taken to increase retention if it becomes necessary to do so. Some of these actions would involve additional expenditures; others probably would not.

Among actions that may not cause additional expenditures and increased attention to retention management and enhancement of some aspects of the quality of military life.

Among actions that would involve additional expenditures are increases in pay and bonuses. With regard to these increases, research has shown that these actions are cost effective relative to the retirement benefits in maintaining retention at adequate levels.

Further, the predicted adverse impact of changing the retirement system are not expected to begin to materialize for at least 10 years; hence, there will be ample time to implement these measures if they become necessary.

POTENTIAL FUNDING DEFICIENCY

The last area you asked us to address was the potential funding deficiency. Because the legislation directing the change of the retirement system has not yet been enacted, DOD will soon need to take action to avoid being in a funding deficiency position. (Unless the President exercises authority granted in section 8009(a) of the 1986 Defense Appropriations Act and, in the interest of national defense, exempts the military personnel accounts from the apportionment provisions of section 1512 of title 31 of the United States Code.) Consequences not intended by the Congress may result unless relief is authorized.

The fiscal year 1986 Defense Authorization Act directed DOD to propose legislative changes to the military retirement system that would achieve a total of $2.9 billion savings in basic pay and retirement accrual.

The Congress did not, however, intend for DOD to reduce basic pay, since the Conference Report on the Authorization Act specifically stated that the $2.9 billion savings was to come from the retirement accural.

DOD cannot reduce its monthly accural charge until the Congress enacts legislation changing the current retirement system.

Since DOD assumes that the Congress did not intend it to reduce force levels, DOD has been spending basic pay and accruing retirement charges at a level in excess of the amounts authorized for fiscal year 1986.

As a result, DOD estimates that if no retirement reform legislation is enacted and it continues to spend at current levels, its military personnel account will be exhausted by approximately September 10, 1986.

To avoid the funding deficiency, DOD submitted an additional legislative proposal to restore $242 million in obligational authority for each month's delay in passing legislation required to effect retirement changes.

From a strictly legal point of view, however, this action by itself is insufficient to solve the funding deficiency problem. As a practical matter, the only way DOD could avoid a funding deficiency is to reduce the force to a level which would result in sufficient funds to pay that reduced force and set aside its retirement accrual for all of fiscal year 1986.

The longer the period required to enact changes in the military retirement system, the greater will be the funding deficiency. Either DOD is granted appropriate relief, or it should be taking steps now to plan and implement actions to comply with the Anti-Deficiency Act.

Mr. Chairman, that concludes my opening statement.

[The prepared statement of Mr. Ferber follows:]

PREPARED STATEMENT OF MARTIN M. FERBER, ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

We are pleased to provide the views of the U.S. General Accounting Office on military retirement reform issues contained in the fiscal year 1986 Defense Authorization Act. This Act reduced the amount of funds that could be obligated from the military basic pay and the retirement accrual accounts and required the Department of Defense (DOD) to submit legislative proposals to reform the military retirement system to meet this reduced obligational authority. On November 21, 1985, DOD submitted its proposals and its views of their potential impact on retention.

You asked for our comments on DOD's proposals, specifically (1) the accuracy of the estimated accrual savings which would result from enacting DOD's proposals, (2) DOD's estimate of the impact on retention, and (3) the potential funding deficiency arising from delays in enacting legislation to change the military retirement system. With me today are Dr. John Harper, who directs our military compensation studies, and Dr. William McNaught, who directs our economics analysis studies.

BACKGROUND

By way of introduction, I would like to briefly discuss (1) the structure of the current military retirement system, (2) the recent change to accrual accounting for retirement annuities, (3) recommendations made in prior studies of the system, and (4) DOD's proposals to change the system.

Current Military Retirement System

The structure of the current military retirement system has remained essentially unchanged since World War II. Its major features include (1) an immediate annuity to a service member who completes 20 years of service, with no annuity for a service member who separates before then, (2) an annuity that ranges between 50 to 75 percent of basic pay depending on the number of years of military service, and (3) an annuity that is adjusted annually for cost of living increases. In addition, the military retirement system is noncontributory. However, the service member contributes to the social security system and thereby earns eligibility for social security retirement benefits. Unlike common private-sector practice, the receipt of the social security retirement benefit does not reduce the level of military retired pay.

The current statutory service requirement for military retirement is 30 years of active duty. Nonetheless, members and retirees frequently refer to the current system as the "20-year" retirement system. Service members do not have the right to retire after 20 years--but only to request retirement and transfer to Reserve status. However, virtually all requests for retirement are granted routinely.

In practice the typical enlisted member or officer retires soon after 20 years of service. Because retired pay is then received for so long, an average of 35 years, its total value is quite substantial. For example, the lump-sum equivalent of

retired pay for a typical enlisted member retiring on January 1, 1985, was $255,003 (in 1984 dollars, assuming a 1.6 percent real interest rate). The comparable amount for a typical officer was $599,149.

Change to Accrual Accounting

In 1984, the Congress required DOD to change its method of accounting for the future retirement cost of current military members. Beginning in fiscal year 1985, the DOD was required to account for its retirement costs using accrual accounting--a method of recording liabilities for retirement benefits earned in one year and setting aside funds in the budget for that year to pay the retirement annuities that eventually will be received. The accrual amount is computed by an independent Board of Actuaries.

DOD's proposals for changing the retirement system are intended to comply with Congressional direction to reduce the retirement accrual funding by $2.9 billion--from $18.2 billion to $15.3 billion in fiscal year 1986. Because the proposals apply only to new members, there will be no reduction in federal outlays until these members begin retiring in 20 years.

If enacted, DOD's proposals would reduce the accrual from 34.0 percent of Regular Military Compensation to 29.6 percent--which is still larger than the current 27.9 percent accrual for the federal civil service workforce and the 22 to 25 percent accrual that would result from enacting some of the proposed changes to civil service retirement the Congress is now considering. Furthermore, while both military and civil service

accrual are stated as a percentage of total personnel cost, the number of service members who historically have received retired pay is lower--13 percent--than the number of civil servants who have historically received retired pay--23 percent.

Prior Study Recommendations

Nine studies conducted since 1969 have recommended extensive structural changes to the military retirement system. The studies have repeatedly identified manpower problems arising from the current retirement system. One problem identified was that retention incentives under the present system become weak after members complete 20 years of service. All nine of the studies--including five done by the DOD--have recommended changes in the system to increase the incentives for longer service careers. While retaining more senior personnel could slow promotions and adversely affect retention rates of junior personnel, those retained are also the most experienced and thus possibly the most productive members of the military. Current trends in manpower requirements tend to emphasize skill and training while placing less importance on "youth and vigor."

Another problem identified was that the current system does not provide retirement benefits (aside from Social Security) for members who fail to complete 20 years of service. Although the services have the option of separating unproductive members involuntarily before 20 years, the prospect of depriving them of benefits makes supervisors very reluctant to use this option. Eight of the nine studies recommended providing earlier vesting

to make it easier to separate personnel involuntarily short of the 20-year point.

DOD's Proposals to Change Military Retirement

As opposed to the major structural changes recommended in prior studies, DOD's current legislative proposals to reform the military retirement system require only minor modifications leaving the basic structure of the current system unchanged.

As directed by the Congress, DOD has developed two options for reducing the retirement accrual funding in fiscal year 1986, and both apply only to those entering on duty after legislation is enacted. One of the two options involves reducing the multipliers for years of service and incorporating high-5 years of basic pay as the basis for determining retired pay. Under this option, retired pay would be equal to 2.15 percent of the high-5 years of basic pay for each year of service up to 20, and 3.2 percent for each year after 20 and up to 30. Full cost of living adjustments would be made. By contrast, under the current system retired pay is equal to 2.5 percent of the high-3 years of pay (or final pay for those entering before September 8, 1980) times the number of years of service up to 30 years.

The second option assumes a high-3 basis and uses multipliers of 2.2 percent per year for 20 years of service, and 3.1 percent for 21 to 30 years. The cost of living adjustment for non-disability retirees would be based on the percentage increase in the Consumer Price Index (CPI) minus one percentage point with a one-time restoral at the 40th anniversary of entry

into the service. Restoral would consist of recomputing retired pay at that point assuming the full CPI had been in effect. Disability retirees and survivors would receive full cost of living protection.

The effect of these changes for the typical enlisted retiree--with 20 years of service--would be to provide between 36 and 40 percent of final basic pay during retirement depending on the option. By comparison, the current retirement system (for those who enlisted since September 8, 1980) will provide about 45 percent of final basic pay.

METHODOLOGY USED TO ESTIMATE ACCRUAL SAVINGS

The first area you asked us to address was the actuarial analysis DOD used to estimate the accrual savings of its proposals. Our objective was to determine whether DOD's analysis was done in accordance with accepted actuarial practice. Our review was limited--in view of the time available to perform it--and consisted of examining an audit recently done by an actuarial consulting firm under contract to the DOD's Board of Actuaries, analyzing evidence gathered during an actuarial audit we conducted in 1982, and discussions with DOD's Chief Actuary.

Based on our review, we conclude that DOD used the methodology and assumptions approved by the Board Actuaries, as required by law, to determine that the proposals would produce the required level of savings in the accrual charges. In appendix I we discuss some technical aspects of DOD's actuarial

analysis that may have implications for accrual cost savings in the long term.

METHODOLOGY USED TO EVALUATE RETENTION EFFECTS

The second area you asked us to address was the methodology DOD used to evaluate retention effects. Unlike assessing the actuarial analysis, evaluating the impact of the proposed changes on retention is a very inexact science because there are few tools available to make such assessments.

It is DOD's assessment that the retirement changes would have severe consequences and result in a loss of about 41,000 service members who would otherwise have remained in the military. However, the consequences of the change, as seen by DOD, have to be analyzed within a context of the uncertainty involved in evaluating a current change that will not have an impact for many years.

At different points in their careers, military members are most influenced by different factors in making career decisions--to include staying in the military or leaving. For example, a DOD report submitted to the House Armed Services Committee last year concluded that monetary variables such as pay, benefits, and civilian employment opportunities were clearly powerful predictors of first-term reenlistment. Variables such as assignment location, quality of life, and job conditions were also important--especially after the first term.

Retention analyses and survey data show that the prospect of retiring at 20 years of service becomes very important only

after the 8 to 10 year point. It is not just the amount of retirement pay that encourages retention, but also the all-or-nothing aspect of the 20-year retirement system and other retirement benefits that are important.

Therefore, it will be 8 to 10 years from a change today before any real impact would become evident. Even then the impact may be indistinguishable from the effects of other factors which might change in the meantime. For example, DOD points out that the adverse effects on retention of the 1980 change to the high-3 years of pay for calculating retired pay were likely mitigated by pay raises and other compensation initiatives such as the variable housing allowance. Other important factors which might change include the state of the economy and the public's attitude toward the military.

Finally, we are talking about a change based on today's force structure and projecting it 8, 10, 20, or more years in the future when no one knows what changes in force structure may be needed to respond to threats to our national security.

With these general cautions in mind, I have some specific comments on DOD's analysis of the projected impact of its proposals on retention. My comments will cover four points:

1. Some positive aspects of a military career.
2. The method used to assess retention effects.
3. The sensitivity of the method to changes in assumptions.
4. Some actions that may be necessary if retention does pose a problem.

Positive Aspects of Military Service

The positive aspects of military life may outweigh any loss of retirement income for those who are considering a military career.

DOD appropriately points out that a military career requires an acceptance of a highly disciplined life and the abridgment of some individual freedoms. Commonly referred to as the "X factor" of military life, it is this very factor that attracts some to a military career. Other positive aspects of military life include job security and various benefits such as free health care and commissary and retail shopping privileges. In addition to also being motivated by patriotism, many military members may view their compensation (even with changes in retirement) as competitive with what they might receive outside the military. In this regard GAO has done analyses for the Senate Appropriations Committee which show that military members take home a greater portion of their income than civil servants at the same salary level.[1]

While the proposed changes will reduce retired pay, it should be noted that the retired service member continues to receive, in addition to pay, other benefits such as commissary and retail shopping privileges--which the military estimates as a 25 percent savings--and free medical care for themselves and

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[1]Military and Federal Civilian Disposable Income Comparisons 1985 Pay Rate (GAO/NSIAD-85-58)

their families. Also at 20-year retirement the service member is provided a financial base from which to start a second career.

In its report DOD raises what it terms a basic question--"If military retirement benefits are too great or too lucrative as some have claimed, why do so few remain for a career?" Part of the answer seems to us to be given in DOD's enlistment slogan "its a great place to start." Many young people are joining the military to (1) learn a technical skill or trade (2) take advantage of the new GI bill and the Army College Fund, which can provide over $25,000 towards college, (3) start a job when one in the private sector may not be available or as attractive, and (4) serve their country. It is usually not until much later that they seriously consider making the military a career.

The Method Used to Estimate Retention Effects

The Congress directed that DOD use the methodology employed by the Fifth Quadrennial Review of Military Compensation (QRMC) in evaluating the impact of its proposals. The QRMC used some of the most advanced methods available to assess the effects on retention of proposals it analyzed. A key part of its methodology was an econometric model. We think it is important to understand what this model can and cannot do.

The model considers only the effect of monetary factors including the effect of deferred compensation in the form of a retirement annuity. It can not assess the effect of such other factors as the loss of individual freedom, the propensity to

serve in the military, the desirable or undesirable aspects of frequent moves or overseas assignments, the quality of military leadership, public attitudes toward the military, and congressional willingness to shore up any retention losses with increases in compensation. And as a result, the predictions made by the model may not come to pass.

The model focuses on the future civilian and military income that an individual service member may be comparing when deciding to stay in, or leave, the service. The income differences are then related to historical retention rates in order to estimate what future retention rates would be, based on changes in the retirement annuity.

Stated another way, the model presumes that individuals considering whether or not to reenlist after the first term evaluate the potential income differences that would exist each year over their lifetimes.

Model Sensitivity

The model used is very sensitive to changes in the variables it evaluates. In its report DOD states that, compared with analysis done by the Army, its projected retention impacts are conservative. We would point out that making slightly different assumptions about these variables could result in significantly different projected impacts.

For example, altering two key variables--that deal with how military members value future income and respond to changes in income--significantly reduces the model's prediction of retention losses.

Our analysis shows that as many as about 12,500 more enlisted personnel in the 11-20 years-of-service group might remain in the service than DOD's analysis indicates. In the 21-30-year group as many as about 1,700 more might remain than DOD's analysis indicates. The analysis for officers shows similar results. (See appendix II for our analysis of the model and its sensitivity to assumptions about key variables.)

What If Retention Is a Problem?

There are actions that can be taken to increase retention if, or when, it becomes necessary to do so. Some of these actions would involve additional expenditures, others probably would not. Among actions that may not cause additional expenditures are increased attention to retention management, changes in leadership style, and enhancement of the quality of military life. Among actions that would involve additional expenditures are increases in pay and bonuses. With regard to these increases, research has shown that these actions are cost-effective relative to the retirement benefits in maintaining retention at adequate levels.[2] Further, as noted above, the predicted adverse impacts of changing the retirement system are not expected to begin to materialize for at least 10 years, according to both DOD's and GAO's analysis. Hence, there will be ample time to implement these measures if they become necessary.

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[2]Congressional Budget Office, Modifying Military Retirement - Alternative Approaches, Washington, D.C.: USGPO, April 1984.

POTENTIAL FUNDING DEFICIENCY

The last area you asked us to address was the potential funding deficiency. Because the legislation directing the change in the retirement system has not yet been enacted DOD is in a funding deficiency position. Unless relief is authorized, consequences not intended by the Congress may result.

The fiscal year 1986 Defense Authorization Act directed DOD to propose legislative changes to the military retirement system that would achieve a total of $2.9 billion savings in basic pay and retirement accrual. However, the Congress apparently did not intend for DOD to reduce basic pay since the Conference Report on the Authorization Act specifically stated that the $2.9 billion savings was to come from the retirement accrual.

DOD cannot reduce its monthly accrual charge until the Congress enacts legislation changing the current retirement system. Since DOD assumes that the Congress did not intend it to reduce force levels, DOD has been spending basic pay and accruing retirement charges at a level in excess of amounts authorized for fiscal year 1986. As a result, DOD faces a potential funding deficiency and estimates that, if no retirement-reform legislation is enacted and it continues to spend at current basic pay and retirement accrual levels, its military personnel account would be exhausted by approximately September 10, 1986.

To avoid the funding deficiency, DOD submitted, along with the two legislative proposals required by the Authorization Act,

an additional legislative proposal to restore $242 million in obligational authority for each month's delay in passing legislation required to effect retirement changes. However, from a strictly legal point of view this action by itself is insufficient to solve the funding deficiency problem and avoid a future violation of the anti-deficiency provision of title 31 U.S.C. 1512, which states:

> "an appropriation available for obligation for a definite period shall be apportioned to prevent obligation or expenditure at a rate that would indicate a necessity for a deficiency or supplemental appropriation for the period."

As a practical matter, the only way DOD could avoid a funding deficiency is to reduce the force to a level which would result in sufficient funds to pay that reduced force and set aside its retirement accrual for all of fiscal year 1986.

DOD recognizes that if its proposed relief legislation is not enacted expeditiously other measures to prevent a funding deficiency will be required, such as an immediate draw-down in the active duty and reserve forces strength levels. A DOD official told us that DOD is still considering ways to avoid the funding deficiency in the event the Congress does not enact the relief legislation.

The longer the period required to enact changes to the military retirement system, the greater will be the funding deficiency. Either DOD is granted appropriate relief or it

should be taking steps to plan and implement actions to comply with the anti-deficiency act.

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That concludes my prepared statement. We would be happy to answer any questions you may have.

GAO OBSERVATIONS ON DOD'S ESTIMATES OF ACCRUAL COST SAVINGS

On the basis of a limited review, GAO believes that the two proposals developed by DOD to reduce the fiscal year 1986 accrual change by $2.9 billion will in fact save that amount. However, during our review we identified two factors related to long term accrual cost which merit the Committee's attention.

First, until now the Board of Actuaries has required use of a method for calculating the accrual charge known as the unweighted normal cost percentage method. This method calculates the accrual charge based on the benefit formula that applies to the most recent group of military recruits. This method was used to estimate the fiscal year 1986 reduction in the accrual charge associated with the two options developed by DOD. However, starting in fiscal year 1987 the Board of Actuaries is requiring use of a new method to calculate the accrual charge. This method is known as the weighted normal cost percentage method and involves calculating separate cost percentages for each benefit formula in effect, and then weighting these by the respective percentages of payroll to obtain a single accrual charge.[1] If a less costly benefit formula is enacted into law, and is grandfathered (i.e., applies only to new recruits) its impact on the weighted normal cost is less than its effect on the unweighted normal cost. Hence,

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[1]The accrual charge is equal to the product of the normal cost percentage and basic pay.

the reduction in the accrual charge associated with these proposals in fiscal year 1987 and succeeding years will be less than $2.9 billion.

Second, the $2.9 billion estimated reduction in the accrual charge is partly based on the assumption that historical retention rates will continue into the future. This is in accordance with accepted actuarial practice and has been approved by the DOD Board of Actuaries and hence is legally binding. However, DOD's analysis of the impact of its proposals predicts that there will be reductions in retention levels, although these reductions are not expected to be observed for 10 years or more. If these predicted reductions come to pass, then:

--Presumably the Board of Actuaries would approve altered retention rate assumptions that reflect these new patterns.

--The normal cost percentage for fiscal year 1986 would have been lower than 42.6 percent.

--The accrual reduction would have been greater than $2.9 billion.

However, as discussed in appendix II, considerable uncertainty exists concerning the magnitude of the effects of DOD's proposals on retention levels.

GAO OBSERVATIONS ON THE ACOL MODEL USED TO ESTIMATE RETENTION EFFECTS OF DOD'S 1985 RETIREMENT PROPOSALS

The Department of Defense's (DOD's) estimates of the potential force structure effects from enacting its proposed retirement changes are derived from a computer simulation model developed by the Fifth Quadrennial Review of Military Compensation (QRMC). Congress had directed the DOD to use this model. The QRMC's model is a version of what military manpower economists call the Annualized Cost of Leaving (ACOL) model. The ACOL model has several advantages in this kind of analysis. First, the model is unique in that it permits analyses of retention for both the officer and enlisted communities of all four services. And second, it is operationally practical to use.

An essential test of the soundness of a model like ACOL involves determining its accuracy in predicting the effects of changes such as those proposed by DOD. Since there have been no major changes to the retirement system on which to test the model's accuracy (the change to high-3 years of pay as the basis for determining retired pay has yet to produce discernible effects), the following tests take on critical importance:

--An assessment of the theoretical validity of the model to determine the extent to which the theory embodied in the model is capable of approximating reality.

--An assessment of the parameters and variables of the model to determine their sensitivity to changes in the key assumptions built into the model.

This attachment presents the results of our assessments of the model's validity, including the results of a sensitivity analysis which demonstrates the range of uncertainty present when it is used to analyze the potential retention effects of DOD's proposed retirement changes.

THEORETICAL VALIDITY

Theoretical validation involves a review of the theories underlying a model and the major assumptions which have been made to adapt the theories to the problem being analyzed. The results of our theoretical analysis are presented in three sections. The first section describes the rationale underlying the ACOL model. The second outlines the major theoretical criticisms of the ACOL model, and the third discusses the QRMC version of ACOL and how it handles these theoretical criticisms.

The Rationale of the ACOL Model

Suppose at age 23 Sergeant Smith is thinking about whether to stay in or leave military service. Even though Sergeant Smith may be able to extend for as little as an additional year, his thinking may go well beyond that--perhaps going to the 20 years needed to qualify for a retirement benefit or even for a full 30-year career.

The ACOL model separates Sergeant Smith's decision into two parts. First, it assumes Sergeant Smith asks "Do I want to remain in military service, or do I want to leave now?" Second, it assumes Sergeant Smith asks "If I choose to stay, for how long should I stay?"

APPENDIX II

If Sergeant Smith were to decide his preferred military career would last up to 30 years of service, Figure 1 illustrates what the ACOL model assumes he considers in terms of future income when deciding whether he is better off separating now or completing this military career. If he separates now, his future income will follow the civilian income line, which in our example is higher than the military income line until age 49.

If he reenlists and stays in military service for a full 30 year career, then his future compensation might follow the military income line. At retirement, he enters civilian life and is compensated along the civilian income line, but also receives an additional military retirement annuity. As drawn on Figure 1, the essence of Sergeant Smith's problem is whether the loss of some higher civilian income between age 23 and age 49 is worth the additional retirement income to be received over the remainder of his lifetime.

The ACOL model reduces this set of income differences to a single number called the Annualized Cost of Leaving or ACOL from which the model takes its name. The ACOL is the annual amount of discounted compensation necessary to eliminate the income difference in Figure 1. A separate ACOL exists for each possible military career length.

To answer Sergeant Smith's first question--"Do I wish to stay in the military?"--the model compares the estimated ACOL value for the different military career lengths to a variable representing his preference for a civilian career, that is:

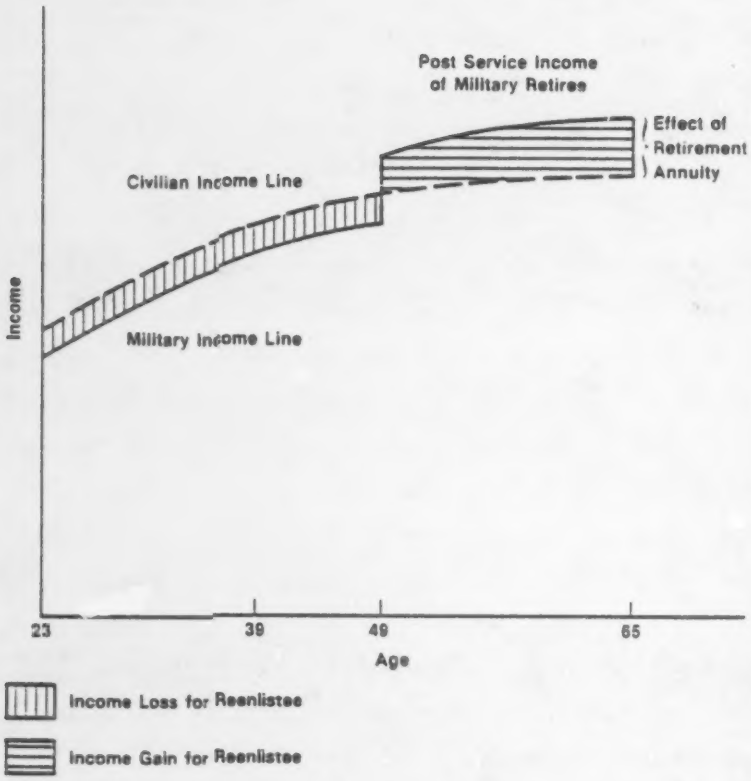

Figure 1: Illustration of Military-Civilian Income Differences

--if the value of ACOL is greater than the preference of a civilian career, he stays.

--if the value of ACOL is less than the preference for a civilian career, he separates.

If there is at least one desirable career length for which the first of these two conditions holds, then the model predicts that Sergeant Smith will stay.

To answer the second question--"How long should I stay?"--the model assumes he chooses the career length that has the largest value over preferences for a civilian career. In most cases, the preferred career length is a single reenlistment term for soldiers with less than 8 years of service, a 20-year career for soldiers with more than 8 to 12 years of service, and a full 30-year career for soldiers with more than 20 years of service.

Sergeant Smith's preferences for civilian or military life cannot be known as far as the model is concerned. They therefore enter the model as a statistical error factor. Thus the ACOL model usually specifies that the probability of reenlistment = f (B_0 + B_1 ACOL) where f represents Sergeant Smith's preferences, ACOL is the annualized cost of leaving, and B_0 and B_1 are the parameters to be estimated.

The specific relationship between ACOL and the probability of reenlistment is assumed to be an S-shaped curve known as the logistic curve. The parameter B_1, known as the labor supply

parameter,[1] is especially important because it determines how large a behavioral response (i.e., lower retention rates) will be predicted in response to a reduction in the level of future retirement benefits.[2]

The ACOL model calculates predicted reenlistment rates for "typical" service members based on the framework described here, and then translates these reenlistment rates into a force profile (i.e., a frequency distribution of personnel by the number of years that they have been in the service). The QRMC ACOL model is a steady-state model which means that it starts with an initial force profile, known as the baseline profile, that is expected to continue into the future in the absence of any changes in compensation of policy. The DOD report, following the QRMC, has used the average continuation rates over the fiscal year 1976 to 1982 period and the associated force profile as a baseline.[3]

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[1]This is closely related to, but not identical to, the concept of "elasticity" that is widely used in military manpower analyses and other economic analyses.

[2]The DOD report asserts that the reenlistment functions used in the QRMC ACOL were estimated from changes in reenlistment bonuses. This is not strictly true, as the QRMC estimated the effect on the retention levels of changes in ACOL and reenlistment bonuses were but one source of variation in the ACOL measure across year-of-service groups. Other sources of variation include all elements of compensation and rank which vary across year-of-serice groups.

[3]Several experts whom we interviewed have suggested that it would be more realistic to use baseline data from a more recent period when retention rates were higher. Because of the lack of model documentation, we were unable to carry out a sensitivity analysis to determine whether DOD's findings would be affected by the use of a more recent baseline period.

The ACOL model calculates new retention rates associated with changes in compensation policy (e.g., changing the retirement system) and derives a new force profile. It is important to note that the model implicitly assumes that the force profile is determined by the decisions of individual service members to stay or leave, and not by service policies that seek to manage the force or congressional constraints.

Major Theoretical Criticisms of the ACOL Model

Two of the major theoretical criticisms of the ACOL model concern how the unknown preferences should be dealt with. The first criticism relates to how preferences for the military change over time for a cohort of entering recruits. Members of the cohort who remain in the military for each successive reenlistment are more likely to have higher preferences for military life (or conversely lower preferences for civilian life) than those who leave. As more individuals with preferences for civilian careers leave the military, the estimated labor supply parameter, B_1, will be overstated as the distribution of preferences becomes more uniform. That is, the impact on retention of a change in military retirement benefits will be overstated. Many users of the ACOL approach, including the QRMC, have added an additional variable, length of service, to control for change in preferences.

The second criticism of the ACOL approach is that it does not take into account the effects of such random events[4] as especially good or bad assignments, or sickness in the family which also influence more people to stay who would otherwise have left. One recent study used simulation techniques to show that to the extent that random events influence retention decisions, the model will underpredict the sensitivity of retention rates to a variety of hypothetical changes in the retirement system.[5]

A third theoretical criticism of the ACOL model involves how the ACOL measure is constructed. The ACOL model is considered a "maximum regret" model because it compares the value of staying until the "best" future decision point with the value of leaving at the current decision point. Therefore, it will not predict any retention effects for pay changes that do not affect the maximum ACOL value and the time horizon over which ACOL values are maximized. This limits the type of policy changes which may be evaluated using this model since there are some policy alternatives which may change the alternative ACOL values but not affect the best ACOL value or time horizon, while other policy changes may lead to abrupt changes in the time horizon. For example, DOD's analysis in its report of the

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[4]This is mentioned both in John Warner, "Alternative Military Retirement Systems: Their Effects on Enlisted Retention," Center for Naval Analysis CRC 376, 1979, and R.Y. Arguden, "Personnel Management in the Military: Effects of Retirement Policies on the Retention of Personnel," Rand Graduate Institute, 1985, as well as in the Fifth QRMC report P. I-51.

[5]A mathematical proof of this is available in Arguden, Appendix A.

option for cutting $5.4 billion in accrual changes is an example of a policy option for which ACOL is not well suited because of this very stringent assumption. In this case, the ACOL model predicted that this option would encourage 30-year careers rather than 20-year careers and thus improve retention despite the severe reduction in the benefit formula, an implausible result.

How the Theoretical Criticisms Have Been Handled

The QRMC ACOL model deals with changes in the distribution of preferences by adding an additional variable to capture the increase in preferences for the military during the first term of service. However, when major shifts in retention patterns (due to sizeable changes in the retirement benefit) are analyzed with this model, this variable will not adequately adjust the model's predictions to the new pattern of preferences among those entering the military. Therefore, the QRMC model will tend to overstate the retention effect of large changes in the retirement benefit, such as eliminating the program.

VALIDITY OF PARAMETERS AND VARIABLES

The major criticism of the validity of ACOL's parameters and variables relates to the variable representing the lifetime earnings available to the service-member making the decision to stay or leave. There are three general components of this variable: military income, civilian income, and the discount rate.

Discount Rates

The annualized cost of leaving is the annualized difference between the present value of the pay stream of remaining in the military or leaving and going to the civilian sector. The critical assumption in determining present value is the individual's personal discount rate. Personal discount rates are the rates at which individuals are willing to trade additional future income for current income. The higher one's personal discount rate, the more strongly one prefers current to future income and, conversely, the less one cares about changes in the expected value of future income. This affects the ACOL model in that the lower the discount rate chosen to calculate the ACOL variable, the more weight given to the retirement benefit in the income stream. With a low discount rate, changes in the retirement policy will cause larger retention effects than with higher discount rates. Therefore, the choice of the appropriate discount rate is critical to the interpretation of changes in the retirement benefit.

In the ACOL model used by the QRMC, a sliding discount rate is computed for both officers and enlisted personnel: starting at 16.5 percent in year one, declining to 7.3 percent in year nineteen, and 7.0 percent in year thirty. The slide is very steep; the average discount rate over thirty years is 8.1 percent. This is a unique approach to estimating the discount rate. Several experts we interviewed question its theoretical justification. However, these experts do not agree on the appropriate discount rate. In fact, the estimates range from 3

to 30 percent. Most reported empirical estimates of personal discount rates have exceeded 10 percent. Analysts favoring relatively low discount rates argue that the military tends to attract people who prefer deferred compensation.

Military Compensation

The QRMC ACOL model calculates military compensation using service-specific strengths by grade and year of service to reflect promotions and special entitlements such as incentive pay or bonuses. Once rank, years of service and special supplemental pays have been established, calculation of the military compensation stream is simple. However, complications arise from the assumptions that must be made about promotions, and thus rank.

The first complication arises from imputing promotion probabilities into the model: individuals who have greater or lesser likelihood of being promoted cannot be identified. The average promotion probabilities are used for all personnel, the differences among individuals--which may change their decisions to stay or leave--become random events in the model. As mentioned earlier, these random events would be expected to exert a downward bias on the estimated coefficient of the ACOL variable.

The second problem in measuring military compensation is that the military's rank structure is constrained by congressional authorizations and service policy. Therefore, promotion opportunities are a function of the force profile (i.e., experience distribution) of the services. If changes in retirement policies cause changes in the force profile,

promotion probabilities could be affected. For instance, if a given change in the retirement system causes large losses of senior personnel, movement through the promotion "pipeline" may increase. From interviews with experts it does not appear that the QRMC ACOL model has taken this into account.[6]

The final complication arises from civilian earnings--particularly the income that retirees will earn when they enter the civilian labor market. There are two major methodological issues involved.

First, the skills learned while in the military may be earnings enhancing only for the first few years in the service. That is, if the individual leaves after the first 4 years (or first term of service) he will probably earn as much or more as his peers in the civilian labor market.[7] However the longer he stays in, the lower his comparative earnings profile may be. Second, individuals who have high civilian income opportunities are more likely to leave military service than those with average or low civilian income opportunities. Therefore when separatees' civilian earnings are compared with the earnings of other veteran, or nonveteran, civilians who were already in the civilian labor market, the differential will be overstated. In this case military personnel are observed to earn less when they

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[6]This should not be taken as a criticism of the developers of the ACOL model. It is likely that explicitly modeling such a "feedback" would substantially increase the computational complexity of the model.

[7]Coopers and Lybrand, Inc. Military Retirees' and Separatee' Post Service Earnings. App. Q to the Fifth QRMC Report.

enter the civilian labor market than their veteran or nonveteran peers because they would have anyway; the military experience itself had no effect.

All these issues highlight why it is extremely difficult to specify the correct alternative income stream for inclusion in the ACOL variable. The QRMC model did not specifically address any of the biases described above and so largely left the problem unresolved.

SENSITIVITY ANALYSIS OF THE ACOL MODEL

Given the uncertainty that exists as a result of the assumptions used in the ACOL model, standard professional practice calls for changing the assumptions within reasonable bounds to determine how sensitive the model's predictions are to the changes. Unfortunately, the structure of the ACOL model and the lack of documentation severely limited our ability to perform such an analysis. We were able, however, to analyze the sensitivity of the model to changes in two of its key variables: the labor supply parameter that indicates how responsive military members are to changes in retirement, and the personal discount rate.

We constructed "low" and "high" assumptions for the labor supply parameter that, according to standard or statistical sampling theory would have approximately a 95 percent probability of including the true value of the parameter. We believe this is a conservative procedure because it only accounts for uncertainty in the parameter associated with statistical sampling, and not

uncertainty associated with the possible flaws in the procedure used to estimate the parameter.

In the case of personal discount rates, we adopted a "low" assumed value of 5 percent--based on a recent study by the Army Research Institute and "high" assumed values of 12.5 percent for enlisted personnel and 10.3 percent for officers--based on a study done for the 5th QRMC.[8]

Our analysis, taken as a whole, is conservative in the sense that we only changed one variable at a time, in order to isolate the effect of each variable. If a sensitivity test were performed on more than one variable simultaneously (e.g., assuming a low supply parameter and a high personal discount rate), the range of estimates of impacts of changing the retirement system would be greater than those presented here.

The results of these analyses are presented in Table 1 through 4. These tables follow the same format as Table 4 of the DOD report in order to facilitate comparison. Although DOD analyzed the effects of the two options for changing the retirement system relative to both the final pay formula in effect before September 1980 and the current high-3 formula, we focus on the latter comparison, because by so doing we isolate the specific predicted effect of the options being considered here, over and above the effect of the implementation of high-3. While we also present only the results of the analyses pertaining

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[8]Matthew Black, "Personal Discount Rates: Estimates for the Military Population." Study prepared for the Fifth QRMC Report, Appendix I, Attachment 3, 1984.

to enlisted personnel; the officer analyses lead to very similar conclusions.

Tables 1 through 5 demonstrate that changing the assumptions can have a significant impact on the model's predictions. For instance, DOD estimates that enactment of the "structure-only" option will lead to the loss of about 29,500 enlisted personnel with between 11 and 20 years of service. The corresponding number is about 19,600 if the high personal discount rate assumption is used, and about 36,200 if a high labor supply parameter is assumed.

Despite this difference, there are certain similarities between DOD and GAO analyses that should be noted. First, the predicted impacts of DOD's two proposals are nearly identical according to both the GAO and DOD analyses. In addition, all of the ACOL model runs predict the options will have very little impact on force strength among members with less than 10 years of service, and an increasing impact as one moves from the 11-20 year group to the 21-30 year group. To a large extent, these generalizations hold because the GAO sensitivity analyses involve altering specific operational assumptions within the same basic theoretical framework as DOD's analysis, and this framework constrains the model's predictions.

TABLE 1

IMPACT RELATIVE TO FORCE MANNING
WITH HIGH-3 AVERAGING

LOW LABOR SUPPLY PARAMETER ASSUMPTION

ENLISTED

	TODAY'S[a] 7-YR AVG	FUTURE HI-3	STRUCTURE-ONLY OPTIONS	COMBINATION OPTIONS
Accessions	332,566	338,798	348,742	348,380
Difference			9,944	9,582
% change			2.9	2.8
YOS-1-4	1,030,789	1,049,868	1,079,447	1,078,403
Difference			29,579	28,535
% Change			2.8	2.7
YOS 5-10	389,147	390,397	387,411	387,557
Difference			-2,986	-2,840
% Change			-0.8	-0.7
YOS 11-20	329,573	323,075	299,868	299,966
Difference			-23,207	-23,109
% Change			-7.2	-7.2
YOS 21-30+	55,232	41,402	38,017	38,814
Difference			-3,385	-2,588
% Change			-8.2	-6.3
YOS 5-20	718,720	713,472	687,279	687,523
Difference			-26,193	-25,949
% Change			-3.7	-3.6
YOS 5-30+	773,952	754,874	725,296	726,337
Difference			-29,578	-28,537
% Change			-3.9	-3.8

[a]The figures in this column may differ from the corresponding figure in the DOD analysis because of rounding error.

TABLE 2

IMPACT RELATIVE TO FORCE MANNING
WITH HIGH-3 AVERAGING

HIGH LABOR SUPPLY PARAMETER ASSUMPTION

ENLISTED

	TODAY'S[a] 7-YR AVG	FUTURE HI-3	STRUCTURE-ONLY OPTIONS	COMBINATION OPTIONS
Accessions	332,534	341,904	357,775	356,592
Difference			15,871	14,688
% change			4.6	4.3
YOS-1-4	1,030,691	1,059,134	1,106,296	1,102,864
Difference			47,162	43,730
% Change			4.5	4.1
YOS 5-10	389,115	390,300	385,535	385,920
Difference			-4,765	-4,380
% Change			-1.2	-1.1
YOS 11-20	329,646	318,926	282,761	283,217
Difference			-36,165	-35,709
% Change			-11.3	-11.2
YOS 21-30+	55,289	36,385	30,146	32,737
Difference			-6,239	-3,648
% Change			-17.2	-10.0
YOS 5-20	718,761	709,226	668,296	669,137
Difference			-40,930	-40,089
% Change			-5.8	-5.7
YOS 5-30+	774,050	745,611	698,442	701,874
Difference			-47,169	-43,737
% Change			-6.3	-5.9

[a]The figures in this column may differ from the corresponding figure in the DOD analysis because of rounding error.

TABLE 3

IMPACT RELATIVE TO FORCE MANNING
WITH HIGH-3 AVERAGING

LOW PERSONAL DISCOUNT RATE ASSUMPTION

ENLISTED

	TODAY'S[a] 7 -YR AVG	FUTURE HI-3	STRUCTURE-ONLY OPTIONS	COMBINATION OPTIONS
Accessions	332,548	342,608	354,775	354,939
Difference			12,167	12,331
% change			3.6	3.6
YOS-1-4	1,030,732	1,060,890	1,097,166	1,097,700
Difference			36,276	36,810
% Change			3.4	3.5
YOS 5-10	389,129	388,556	385,460	385,529
Difference			-3,096	-3,027
% Change			-0.8	-0.8
YOS 11-20	329,615	318,054	288,089	286,717
Difference			-29,965	-31,337
% Change			-9.4	-9.9
YOS 21-30+	55,262	37,242	34,023	34,801
Difference			-3,219	-2,441
% Change			-8.6	-6.6
YOS 5-20	718,744	706,610	673,549	672,246
Difference			-33,061	-34,364
% Change			-4.7	-4.9
YOS 5-30+	774,006	743,852	707,572	707,047
Difference			-36,280	-36,805
% Change			-5.0	-4.9

[a]The figures in this column may differ from the corresponding figure in the DOD analysis because of rounding error.

APPENDIX II

TABLE 4

IMPACT RELATIVE TO FORCE MANNING
WITH HIGH-3 AVERAGING

HIGH PERSONAL DISCOUNT RATE ASSUMPTION

ENLISTED

	TODAY'S[a] 7 -YR AVG	FUTURE HI-3	STRUCTURE-ONLY OPTIONS	COMBINATION OPTIONS
Accessions	332,559	337,504	345,910	344,666
Difference			8,406	7,162
% change			2.5	2.1
YOS-1-4	1,030,765	1,046,111	1,070,831	1,067,084
Difference			24,720	20,973
% Change			2.4	2.0
YOS 5-10	389,142	391,146	389,602	389,240
Difference			-1,544	-1,906
% Change			-0.4	-0.5
YOS 11-20	329,592	324,856	305,269	306,807
Difference			-19,587	-18,049
% Change			-6.0	-5.6
YOS 21-30+	55,246	42,624	39,032	41,606
Difference			-3,592	-1,018
% Change			-8.4	-2.4
YOS 5-20	718,734	716,002	694,871	696,047
Difference			-21,131	-19,955
% Change			-3.0	-2.8
YOS 5-30+	773,980	758,626	733,903	737,653
Difference			-24,723	-20,973
% Change			-3.3	-2.8

[a]The figures in this column may differ from the corresponding figure in the DOD analysis because of rounding error.

TABLE 5

SUMMARY OF DOD AND GAO ANALYSES OF IMPACTS RELATIVE TO FORCE WITH HIGH-3 AVERAGING MANNING

Losses YOS 11-20	Structure-only options	Combination options
DOD Assumptions	29,510	30,620
Low Labor Supply Parameter Assumption	23,207	23,109
(Difference)	-6,303	-7,511
High Labor Supply Parameter Assumption	36,165	35,709
(Difference)	6,655	5,089
Low Personal Discount Rate Assumption	29,965	31,337
(Difference)	455	717
High Personal Discount Rate Assumption	19,587	18,049
(Difference)	-9,923	-12,571
Losses YOS 21-30+		
DOD Assumptions	4,084	2,751
Low Labor Supply Parameter Assumption	3,385	2,588
(Difference)	-699	-163
High Labor Supply Parameter Assumption	6,239	3,648
(Difference)	2,155	897
Low Personal Discount Rate Assumption	3,219	2,441
(Difference)	-865	-310
High Personal Discount Rate Assumption	3,592	1,018
(Difference)	-492	-1,733

SUMMARY

GAO's examination of the methodology used by DOD to analyze the force manning effects of the two options for changing the military retirement system leads to the following observations:

1. The ACOL model represents the best analytical tool currently available for quantifying the impact of the proposed changes in the retirement system on retention of service members, and hence the force profile.
2. DOD correctly applied the ACOL model in analyzing the likely impact of the two principal options presented in the DOD report.
3. There is significant uncertainty concerning the specific economic and behavioral assumptions that ought to be employed in applying the ACOL model to the analysis of policy options such as the changes in the retirement systems currently under consideration. Under certain reasonable assumptions, the force manning impacts could be significantly smaller than those predicted by DOD, whereas under other reasonable assumptions, the impacts will be greater than indicated by the DOD analysis. Policymakers should be aware of this range of uncertainty.

Senator WILSON. Mr. Hale, do you want to go ahead, and then we will have questions for both of you.

STATEMENT OF ROBERT F. HALE, ASSISTANT DIRECTOR, NATIONAL SECURITY DIVISION, CONGRESSIONAL BUDGET OFFICE

Mr. HALE. Mr. Chairman, I am pleased to appear before your subcommittee today to talk about DOD's retirement plans.

I will focus on three issues: the changes that can be expected to generate the saving mandated by the Congress; what will be the effects of these changes on military retention; and how much confidence you ought to place in those cost savings and manpower effects.

As I think you know, both plans would reduce retirement benefits earned up to 20 years of service but would increase them for those with between 20 and 30 years of service.

In addition, one plan that I will call the COLA-minus plan would cut cost of living allowances, and another plan which I will call the high-5 plan, would keep full inflation protection but would calculate retired pay on the basis of the retiree's highest 5 years of service rather than 3 highest, as under current law. Both plans, of course, would be fully grandfathered.

I will briefly summarize our conclusions before presenting them in more detail. Using DOD's accounting methods—and that is important—the Congressional Budget Office [CBO] estimates that the Department's proposals would generate savings that come quite close to meeting the annual target of $2.9 billion mandated by the Congress. Indeed, CBO estimates that savings would be even closer if expected changes in the composition of military forces were taken into account. These changes would slow the growth of the number of career personnel in the military services, and eventually would result in a career force roughly 3 percent smaller than under the current retirement system.

Alternatively, the Congress and DOD could offset much or all of these losses in career personnel by raising reenlistment bonuses or other personnel benefits. The total costs of those increases in bonuses and benefits would be considerably smaller than the savings from lower retirement benefits.

Let me turn now to more detail, and I will start with the costs. In the 1986 Authorization Act, as you well know, you mandated a reduction of $2.9 billion in the accrual charge, 16 percent of the 1986 costs, which will total $18.2 billion.

CBO estimates that DOD's plans, if applied to all those entering at the beginning of fiscal year 1986 and thereafter, would come very close to offering accrual savings of the magnitude mandated by the Congress. In particular, the COLA-minus plan would save $2.7 billion by our estimates, while the high-5 plan would save $2.8 billion.

In practice, savings might even be modestly higher. To estimate the accrual costs, the DOD actuary assumes that current patterns of military retention will persist into the future unchanged; but if retention varied in response to retirement, and we expect it would,

then you might save $2.8 billion and $2.9 respectively under COLA-minus and high-5 plans.

Now, all of these estimates of savings, Mr. Chairman, depend critically on the accounting methodology employed by DOD for 1986, and let me see if I can do a better job of explanation this time.

The Department estimates current accrual costs based on the retirement system in effect for personnel who enter service in 1986. That means that they estimate accrual costs only for the retirement system that applies to new entrants, not for any grandfathered people.

The Department has announced that beginning in 1987 it will change its methodology to reflect the use of different retirement systems for different groups of service members. When applied to the DOD retirement plans that are now proposed, with their full grandfathering, this new method of cost calculation will yield much smaller savings in the early years than I have just noted.

CBO estimates that in 1987 savings would be only about $500 million rather than $2.8 to $2.9 billion. Now, in the later years savings would increase until, when all members were covered under the new system, total savings even under the new calculation method would still approach the congressional target. It is really only in the early years that you are going to get this difference under that new method.

Let me turn finally in my discussion of costs to effects on outlays. As you know, all this debate has been in terms of accrual charges which set-aside money for future retirement pay, and they do not affect current Federal outlays at all.

The plans offered by DOD would immediately affect Federal outlays because of changes in retention, although major impacts would not be felt for many years. For the first full decade after enactment of the new retirement system, we estimate that outlays would increase by between $10 million to $20 million a year, as compared with total personnel costs of approximately $60 billion. Thus, it is really a tiny fraction.

During the second decade after enactment, net outlay savings would begin to be realized, but they would still be small relative to that total. Significant outlay savings would only begin approximately 20 years after enactment.

Cost, of course, is not the only criterion against which these retirement plans should be evaluated. The military compensation system has as its primary goal maintaining the forces we need, and I think it is widely agreed that the retirement system is one of the prinicpal incentives for keeping career personnel in the services.

It is not surprising, therefore, that changes in the plan would affect numbers of career personnel willing to remain. CBO estimates that the retirement changes proposed by DOD would eventually decrease the size of the career force by about 3 percent. The high-five plan would also produce a very slightly less experienced career force than either the current system or the COLA-minus plan. Under either proposal, annual accession requirements would increase also by about 3 percent in order to maintain overall end strength.

I think it is important that you put these projected changes in context. All four services have enjoyed substantial growth in the size of their career forces in recent years, with increases averaging 3 percent per year since 1978.

Moreover, in the absence of retirement changes growth is likely to continue if future military pay keeps pace with that in the civilian sector. Reductions in retirement benefits that we are talking about here would slow, though not halt the growth in the career force. Indeed, under the DOD plans, we estimate that in the long run the size of the military career force would still be 1 percent to 2 percent above its 1984 level.

In its report on options to reduce military retirement costs, DOD concludes that personnel losses would be considerably more severe than what we estimate. Much of the difference between us stems from DOD's choice of what we believe is an inappropriate starting point.

The Department's report refers to its baseline, against which it makes all its comparisons, as "today's force." But it is actually the force profile that would result in the long run—well into the next century—from a retirement system with annuities based on terminal basic pay rather than on the high-three average.

CBO believes the high-three average is the appropriate baseline, because in the long run everybody is going to be under high-three.

Another important factor is that DOD bases its projections on observed military retention behavior during the period 1976 to 1982. That was a period when military pay consistently lagged behind civilian pay, and as a result we had very low retention rates.

CBO's projections assume that future pay increase for the military and civilian sectors will be about the same, and therefore we have assumed that recent retention experience is a better guide. It has a dramatic effect on some of the comparisons the Department of Defense is making.

After we adjust for these differences, DOD's projections show approximately a 4-percent decline in the longrun career force below what it would be under the current system. We show approximately 3 percent, but even with their more pessimistic projection the change in military retirement would merely halt future growth in the career force, leaving the services with about the same number of career personnel as they have today. The full extent of the slowdown would, of course, only be felt gradually as members make retention decisions over a period of many years.

Underlying all of our estimates of the effects of military retirement are mathematical and statistical analyses of how the pay and benefits affect retention decision. These analyses rely on the ACOL model that Marty has discussed, the annualized cost of leaving military service.

At your request, my prepared testimony evaluates briefly these modeling techniques. I will simply say that ACOL, though certainly not without flaws, is the best and most comprehensive tool that we have available to make these estimates, and it is the model currently used by the Department of Defense.

Moreover, even if ACOL projections should prove wrong and the manpower consequences should prove more than we expect, the Congress and DOD would have many remedies at hand other than

simply raising retirement benefits again. These remedies would include raising current pay or reenlistment bonuses.

The costs associated with any of these policy changes would offset some of the savings from reducing retired pay, but net savings should remain. I think that is the important point to keep in mind, because some of these alternative elements of pay and benefits, particularly bonuses and special and incentive pays, are more efficient retention incentives than retirement. In all likelihood, the additional costs of increasing bonuses or specialty pays would not amount to more than a small fraction of the $2.9 billion in savings that would eventually be realized each year under the DOD plan.

In conclusion, Mr. Chairman, CBO's evaluation of the military plans submitted by the Department of Defense suggests that both of the DOD plans would come quite close to the targets you set for savings. Under either plan, losses in career forces would eventually total approximately 3 percent, slowing but not halting all of the growth in the career force. If the Congress wishes to offset these career losses, it could do so with bonuses or special pays and still realize savings.

That concludes my statement, Mr. Chairman. I would be glad to try to answer questions.

[The prepared statement of Mr. Hale follows:]

PREPARED STATEMENT OF ROBERT F. HALE, ASSISTANT DIRECTOR, NATIONAL SECURITY DIVISION, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to appear before your subcommittee this afternoon to discuss the military retirement system. As you know, changes in military retirement have been proposed by many studies during the past 15 years. Most recently, the Department of Defense (DOD) has submitted two alternative plans in response to a requirement stated in the fiscal year 1986 Defense Authorization Act.

In discussing DOD's plans, I will focus on three issues: whether the changes can be expected to generate the cost savings mandated by the Congress; what will be the effects of these changes on military personnel and force profiles; and how much confidence should be placed in these projections of cost savings and manpower effects.

SUMMARY

The Department has submitted two plans for the Congress to consider. The principal features of the plans are summarized in Table 1. Both plans would reduce the retirement benefits earned for service up to 20 years and would increase the credit for service between 20 and 30 years. In addition, one plan—which I will refer to as the "COLA-Minus" plan—would reduce cost-of-living allowances. The other plan—which I will call the "High-Five" proposal—would keep full inflation protection, but would calculate retired pay on the basis of the retiree's five highest years of pay, rather than the three highest as under current law. Both plans would apply only to those retirees who enter service after enactment of the new provisions—that is, current service personnel and retirees would be "grandfathered" and so would remain under the current system.

Let me summarize the Congressional Budget Office's (CBO's) conclusions before presenting our results in detail. Using DOD's accounting methodology, CBO estimates that the Department's proposals would generate savings that come quite close to meeting the annual savings of $2.9 billion mandated by the Congress. Indeed, CBO estimates that savings would be even closer to the $2.9 billion target if expected changes in the composition of military forces were taken into account. These changes would slow the growth of career personnel in the military services, and would eventually result in a career force roughly 3 percent smaller than under the current retirement system. Alternatively, the Congress and DOD could offset much or all of these losses of career personnel by raising reenlistment bonuses or other personnel benefits. The total cost would be considerably smaller than the savings from lower retirement benefits.

COST SAVINGS

Accrual Savings. In the fiscal year 1986 Defense Authorization Act, the Congress instructed the Department to report on ways to reduce the accrual cost of the military retirement system by $2.9 billion, or 16 percent of the estimated fiscal year 1986 cost of $18.2 billion.[1] The Department's costs estimates are based on the "entry age normal cost" of the retirement system. Normal cost can be thought of as the percentage of basic pay that would have to be set aside in a trust fund in order to build a principal amount large enough to pay future retirement benefits. The Department's calculation results in a normal cost percentage of 50.7 for fiscal year 1986 and an accrual charge of $18.2 billion in the President's budget.

The DOD proposals would reduce this accrual cost. As the upper half of Table 2 indicates, CBO estimates that the DOD plans—if applied to all those entering service in fiscal year 1986 and thereafter—would come very close to offering accrual savings of the magnitude mandated by the Congress. The "COLA-Minus" plans would save $2.7 billion annually, while the "High-Five" plan would save $2.8 billion. Under either plan, about $1.7 billion in savings would follow from the change in annual retirement credits, with the remainder being the results of either the reduced inflation protection or the use of "high-five" averaging.

In practice, savings might even be modestly higher. To estimate accrual cost, the DOD Actuary assumes that current patterns of military retention will persist into the future. This assumption is open to challenge. Because military retirement is a major element of the military compensation system, changes in retirement should be expected to affect retention.

If retention varied in response to the changes in military retirement, then reduced benefits for retirees would lead to a decline in the number of military personnel remaining in service long enough to qualify for retired pay. In that event, as shown in the lower half of Table 2, the reductions in the accrual cost of the retirement system would amount to $2.8 billion and $2.9 billion, respectively, under the "COLA-Minus" and "High-Five" plans.

Changes in Methodology. All of the preceding estimates of savings in accrual costs depend critically on the accounting methodology employed by DOD for fiscal year 1986. The Department estimates current accrual costs based on the retirement system in effect for personnel who enter service in 1986. Therefore, DOD estimates accrual costs only for the retirement system that applies to new entrants—not the system for grandfathered personnel. To the extent that senior members are grandfathered under more generous retirement systems, DOD's accrual costs understate the long-term costs of military retirement.

The Department has announced that, beginning with the budget for fiscal year 1987, it intends to change its accounting methodology to reflect the use of different retirement systems for different groups of service members. Accrual costs for personnel who entered service prior to September 8, 1980, will be based on their terminal basic pay. Costs for members who have entered since then will be based on their "high-three" basic pay. And if a new retirement plan, such as the ones presented by DOD, is applied to members who enter in 1986 or beyond, with current personnel being grandfathered under previous systems, the lower accrual costs of the plan will be estimated only for the new groups of personnel.

When applied to the retirement plans that DOD now proposes, with their full grandfathering, this new method of cost calculation will yield much smaller savings in the early years than those noted above. In fiscal year 1987, for example, only personnel in their first two years of service would be covered by the new plan, with an accrual cost of about 43 percent rather than the 51 percent that DOD now estimates for the current system. Based on CBO's estimate of the aggregate basic pay of the different groups of personnel, the 1987 savings would be only $500 million or so rather than $2.8 billion to $2.9 billion. In later years, savings would increase until,

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[1] The accrual cost of military retirement appears in the Department of Defense budget function 050 as both budgetary authority and outlays. Following transfers to the Military Retirement Trust Fund (function 600) and offsetting receipts and expenditures in other accounts, total federal budgetary authority for military retirement is equal to defense budgetary authority. Federal outlays for military retirement, however, different from defense outlays because federal outlays are paid to current retirees, while defense outlays are set aside to pay future retirees. The difference between defense and Federal outlays accumulates in the Military Retirement Trust Fund, where it is supplemented by a payment from the defense budget (function 054) to amortize the unfunded liability of the trust fund. For a more complete description of these accounts, see Congressional Budget Office, Accrual Accounting for Military Retirement: Alternative Approaches (June 1983).

when all members were covered under the new system, total savings would approach the congressional target.

Federal Outlay Reductions. The discussion above, and the cost reduction targets in the Authorization Act, are stated in terms of budgetary authority and accrual charges, which simply set aside funds to pay future retirement costs and so do not affect current federal outlays. But the plans offered by DOD would affect federal outlays, although major impacts would not be felt or many years because of the full grandfathering of current retirees and military personnel now in service. Indeed, outlays for nondisability retirement benefits would not begin to be affected until the first group of entrants under the new plan reached retirement age—20 years from now.

In the meantime, however, the change in retention incentives would alter the composition of the military forces, as I will discuss in the next portion of my statement. The new forces would be characterized by smaller outlays for current pay and benefits, because retention incentives would be weaker for senior personnel and thus the force would include a larger proportion of junior personnel. On the other hand, outlays would be higher for accession and training.

For the first decade after enactment of a new retirement system, increased outlays for accession and training would exceed the pay savings from a more junior force. CBO estimates that these net outlays would be quite small, on the order of $10 million to $20 million annually. During the second decade after enactment, net outlay savings would be realized, but they too would be small compared with the overall cost of the military personnel system, which would continue to be well in excess of $60 billion annually (in 1986 dollars). Significant outlay savings would begin only 20 years after enactment, when the first personnel retired from active service under the new plans.

MANPOWER EFFECTS

Cost is not, of course, the only criterion against which these retirement plans should be evaluated. The military compensation system has as its primary goal the maintenance of a military force of adequate size and experience, and it is widely agreed that the military retirement system is one of the principal incentives for career military personnel to remain in service.

CBO Estimates. The impact of retirement benefits of military retention has been incorporated in CBO's analyses of previous proposals to change the military retirement system, most recently in a report, Modifying Military Retirement, issued in April 1984. CBO bases its estimates on quantitative analysis of the link between historical changes in military compensation and retention. The same methodological approach has been used by the Department of Defense, non-Defense study commissions, and academic researchers. To focus on the effects of changes in military pay and benefits, end strength—the overall number of people in uniform—is usually held constant and shifts in the composition of the force are analyzed.

As the estimates in Table 3 show, savings cannot be realized from retirement changes without some loss of career personnel (defined as those with more than four years of service). Assuming no other changes in military pay and benefits, either of the DOD plans would eventually decrease the size of the career force by approximately 3 percent. The "High-Five" plan would also produce a slightly less experienced career force than either the current system or the "COLA-Minus" plan. Under either proposal, annual accession requirements would increase in order to maintain overall end strength.

While important, these projected changes must be placed in context. All four services have enjoyed substantial growth in the size of their career forces in recent years, with annual increases averaging 3 percent since 1978. In the absence of retirement changes, growth is likely to continue if military pay raises keep pace with those in the private sector. Reductions in retirement benefits would slow this growth, but not halt it. Indeed, under the DOD plans, CBO estimates that in the long run the size of the military career force would still be 1 percent to 2 percent above its 1984 level.

Comparison with DOD Results. In its report on options to reduce military retirement costs, DOD concludes that personnel losses would be considerably more severe than CBO's estimates. For example, DOD projects losses of approximately 61,000 career enlisted personnel and 6,900–7,000 career officers, compared with CBO's estimate of 27,000–34,000 total career personnel. It is important to understand the differences between CBO's estimates and those of the department, as summarized in Table 4.

Most of the difference stems from DOD's choice of what CBO believes to be an inappropriate starting point. The Department's report refers to the baseline as "today's force," but it is actually the force profile that would result in the long run—probably well into the next century—from a retirement system with annuities based on terminal basic pay rather than the "high-three" average. CBO believes that the "high-three" baseline is the appropriate one for any long-run comparison inasmuch as under current law all annuities will be calculated on the basis of "high-three." [2] When DOD estimates personnel changes against the baseline on a "high-three" career force, as CBO does, losses total about 4 percent, or 41,000–42,000 rather than 67,000–68,000 personnel.

Some of the remaining difference between the CBO and DOD estimates occurs because DOD's projections are based on observed military retention behavior during the 1976–1982 period when military pay consistently lagged behind civilian pay, resulting in low retention rates. CBO's projections assume that future pay increases for the military and civilian sectors will be the same; therefore, CBO used more recent retention experience as a guide.

Still other minor differences between the CBO and DOD estimates follow from technical assumptions. For Example, CBO assumes a slightly higher value than does DOD for the extent of service members' preference for current over future income. We do not believe that these differences in assumptions are important for purposes of evaluating the effects of the DOD retirement options.

Because of these differences DOD's projections show a reduction of about 4 percent in the size of the long-run career force as the result of retirement changes. CBO projects a reduction of about 3 percent. But even under DOD's more pessimistic projection, the change in military retirement would merely halt future growth in the career force, leaving the services with about the same numbers of career personnel as are in the force today. And the full extent of the slowdown would be felt only gradually, as members made retention decisions over a period of several years.

CBO METHODOLOGY

Underlying CBO's estimates of the effects of military retirement are mathematical and statistical analyses of how the pay and benefits of military personnel affect their retention decisions. These analyses are summarized in the ACOL model, so called because its central feature is the calculation of the Annualized Cost of Leaving military service. The validity of ACOL and similar approaches has sometimes been called in question. As you requested, I would like briefly to describe and evaluate these modeling techniques.

ACOL was originally developed to support the deliberations of the President's Commission on Military Compensation, which reported in 1978. Since then, successive versions of the basic model have been used for a number of purposes in addition to analyzing the effects of alternative military retirement systems. Among these applications are:

Project the change in Navy retention from increased sea pay;

Administer the Selective Reenlistment Bonus (SRB) program in all four services;

Estimate the effect of educational benefits on career retention; and

Assess the career force changes that would result from the "catch-up" military pay raises in fiscal year 1981 and 1982, and the "comparability" raises of recent years.

The version of ACOL currently used by CBO and underlying the estimates in Table 3 was developed by the Fifth Quadrennial Review of Military Compensation in 1983–84. This model bases its estimates of retention on comparisons between civilian wages and salaries, on the one hand, and total military compensation, including retirement and special and incentive pays, on the other. The economy's unemployment rate is also incorporated in the model's estimates.

ACOL is not the only model of military retention, nor is it without flaws. A more comprehensive analytical framework for estimating retention has been developed by the Rand Corporation, but to date it has been applied only to Air Force officers. Economists at the U.S. Military Academy have used a somewhat different theoretical framework to estimate Army enlisted retention. Under contract to the DOD office of civilian personnel policy, Systems Research and Applications Corporation has modified ACOL to account for the revealed preferences of civilian workers. CBO is currently pursuing application of the SRA model to a population of Navy enlisted personnel.

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[2] Terminal basic pay is the annuity computation base only for personnel who entered service before September 8, 1980.

All of these analytical approaches agree with the general proposition that compensation is an important factor in determining retention. They differ somewhat in their estimates of the extent to which retirement changes would affect retention, while agreeing that retirement is an important career incentive. Of these various approaches, ACOL is currently the only comprehensive model available for estimating military retention.

Past estimates made using ACOL have proved to be sound bases for policy formulation. ACOL successfully projected the improvement in Navy career force manning in the wake of sea pay increases. The model accurately estimated the additional retention from the 1981-1982 pay raises. Moreover, its projections of additional separations among career force personnel desiring to use their educational benefits have been supported by survey results and observed behavior.

Unfortunately, there is no similar track record for ACOL with respect to military retirement. The most significant change in the retirement system was the switch to "high-three" averaging for retirees who entered service after September 7, 1980. In theory, the "high-three" provision should lower the retention incentive, and indeed ACOL estimates that "high-three" will decrease the career force by 2 percent. But members who have entered service under the "high-three" provision have reenlisted at higher rates than cohorts who entered service just prior to the 1980 date.

This single instance, however, does not provide a test of the validity of ACOL to project the effects of changing retirement. Both analysis and survey results confirm that the retirement system is a powerful retention incentive primarily for those members who have completed two or more enlistments—six to eight years of service. "High-three" currently affects only those members who have completed fewer than five years of service. In any event, the experience of the last five years would not provide a good guide for the future because of the sharp fluctuations in unemployment that have occurred since 1980.

One final issue concerning ACOL and other models of military retention addresses the technical assumptions that must be made in order to estimate the effects of policy changes. Among the significant factors are: the discount rate that expresses service members' preference for current over future income; the "baseline" retention that would occur if there were no changes to the current compensation system; and the underlying quantitative relationship between retention and compensation.

Analysts differ as to the specific assumptions that should be made. But while the specific quantitative results in Tables 2 and 3 would be different under alternative assumptions, the qualitative conclusions would not change. That is, CBO would still find that the DOD plans for military retirement would result in some career force losses in terms of both size and average experience, and thus in some additional accessions to maintain a constant end strength. Both plans would lead to sizeable savings in accrual charges, on the order of the $2.9 billion mandated by the Congress.

Finally, even if the ACOL projections should prove wrong and the manpower consequences should be more adverse than estimated, the Congress and the Department would have many remedies at hand in addition to raising retirement benefits. The options for maintaining career force size and experience would include:

Raising current pay, as was done successfully in 1981 and 1982;

Increasing bonuses and special and incentive pays, as the Congress has done regularly; and

Improving military benefits such as travel reimbursements, housing, and "quality of life" programs.

The costs associated with any of these policy changes obviously would offset some of the savings from reducing retired pay. But net savings should remain, because some of these alternative elements of pay and benefits—particularly bonuses and some special and incentive pays—are more efficient retention incentives than retirement. In all likelihood, the additional costs of increasing bonuses or special pays would not amount to more than a small fraction of the $2.9 billion (in constant 1986 dollars) that would eventually be saved each year under the DOD plans.

CONCLUSION

CBO's evaluation of the military retirement plans submitted by the Department of Defense suggests that both of the DOD plans would result in estimated accrual savings quite close to the $2.9 billion specified in the fiscal year 1986 Defense Authorization Act, based on the costing methodology employed by the DOD Office of the Actuary. Under either plan, career force losses would eventually total approximately 3 percent, slowing but not halting the growth in the career force and gradually leading to annual accession increases of 3 percent in order to maintain constant end strength.

These conclusions stem from applying CBO's models of military retention and personnel cost. There is an element of uncertainty in any such model, and CBO's are no exception. But the ACOL model has successfully projected manpower changes resulting from many different compensation policy initiatives, and it provides the best available estimate of the effects of the proposed retirement changes.

Mr. Chairman, this concludes my prepared statement. I will be happy to try to respond to your questions.

TABLE 1.—DOD RETIREMENT PLANS

	Current system	"High-five" (structural) plan	"COLA-minus" (combination) plan
Multipliers (percent):			
Years 1 to 20	2.5	2.15	2.2
Years 21 to 30	2.5	3.20	3.1
Maximum percentage	75.0	75.0	75.0
Retired pay computation base	(1)	(2)	(1)
Inflation protection	(3)	(3)	(4)

[1] Average of highest 3 years' basic pay.
[2] Average of highest 5 years' basic pay.
[3] Full COLA for all retirees.
[4] CPI minus 1 percent for all retirees; restoral at 40th anniversary of entry into service.

Source: Congressional Budget Office.

TABLE 2.—COST SAVINGS FROM RETIREMENT CHANGE

[Change from current system]

Methodology	"High-five" (structural)	"COLA-minus" (combination)
Assuming constant retention (DOD methodology):		
Change in normal cost percent	15.3	14.9
Fiscal year 1986 savings (billions of dollars)	2.8	2.7
Assuming variable retention (CBO) methodology):		
Changes in normal cost percent	16.0	15.5
Fiscal year 1986 savings (billions of dollars)	2.9	2.8

Source: Congressional Budget Office.

TABLE 3.—MANPOWER EFFECTS OF RETIREMENT CHANGES

Category	Current system	"High-five" (structural)	"COLA-minus" (combination)
End strength	2,228,000	2,228,000	2,228,000
Career force size	1,128,000	1,093,000	1,101,000
Average experience of career force (years)	11.9	11.7	11.8
Annual accessions	331,000	342,000	339,000

Source: Congressional Budget Office

TABLE 4.—COMPARISON OF CBO AND DOD ESTIMATES OF PROJECTED CAREER FORCE LOSSES

[In thousands]

Estimates	"High-five" (structural)	"COLA-minus" (combination)
DOD estimate (High-terminal basic pay; 1976–82 average retention)	67.9	67.8
Adjusted for high-three instead of high-terminal pay	41.6	41.5
Adjusted for current instead of 1976 to 1982 average retention	39.7	40.1
CBO estimate (High-three basic pay; current retention)	34.1	27.0

Source: Congressional Budget Office.

Senator WILSON. Thank you very much, Mr. Ferber and Mr. Hale, for what I think are excellent presentations, and they will be of great value to us.

Mr. Ferber, in your testimony you characterize the Department of Defense proposals as minor modifications in contrast to the major structural changes recommended in prior studies.

In testimony yesterday we heard a very different view expressed. The Departmental witnesses described the proposals as making deep and fundamental change. Would you explain why you termed these minor modifications?

Mr. FERBER. Yes, Mr. Chairman, but first, with your permission, I would like to have two people join me to help respond to any questions.

Senator WILSON. Fine.

Mr. FERBER. That would be Dr. John Harper, who directs our military compensation studies, and Dr. Bill McNaught, who directs our economic analysis studies.

Mr. HALE. I will also ask Neil Singer to join me. Neil supervised our work.

Mr. FERBER. Mr. Chairman, our comment that the changes were minor stems from a review of the nine prior studies in military reform. All these studies have recommended changes well beyond what the DOD's proposals consider.

In addition to changing the allowance formulas, they all recommend earlier vesting, usually at the 10-year point, so that a service member could leave the service earlier with some kind of benefits rather than the all or nothing aspect of the 20 year.

Several of them also integrate military retired pay with Social Security, which it currently does not.

Finally, one of them recommend that it be a contributory system.

As far as commenting on DOD's projection of the severe consequences, I go back to my statement where we said that the model that they used to come up with that is very sensitive to changes in assumptions.

Likewise, Mr. Hale talked about maybe the base being inappropriate. If you look at the model with either changing the base or the sensitivity analysis that we did, in either case you come up with much less impact on retention.

Finally, as Mr. Hale said, there are some cost effective alternatives that can be implemented if necessary.

Senator WILSON. Thank you.

We are going to vary a little bit from the normal procedure. Senator Exon has joined us and has asked if he might ask a couple of questions. He is required to be elsewhere, and we will be happy to honor his request.

Senator EXON. Mr. Chairman, thank you for your consideration. We have an SDI hearing going on at the same time as this. Both cover important issues and I appreciate being able to attend both.

This is a tremendously interesting proposal, and I am sorry that I could not be here for the previous witnesses. I have just two quick questions that will not take more than 5 minutes, and I appreciate the consideration of both you and Senator Glenn.

Have you had a chance to do any study on the Simon proposal, and do you agree with the estimated savings of the Simon proposal if it were put into effect?

Mr. HALE. Those numbers are ours, Senator Exon. Yes, we would agree with them. I would add that we did not add them up over a 50-year period using inflated dollars. You have to understand, obviously, that you should compare those with, say, total Federal spending over 50 years in inflated dollars.

Senator EXON. To use an old, wornout phrase, it's in the ballpark?

Mr. HALE. I think so, as best we can tell.

Senator EXON. Do you agree?

Mr. FERBER. We have done no analysis on it, sir.

Senator EXON. Studies of the costs are very, very important because we have a budget problem that is going to cause us great concern, I feel, in our defense buildup.

In the studies that you have done, have you considered the number of years service required for retirement? I have some grave concerns regarding retirement after only 20 years of service.

For reasons that have never been adequately explained to me, some awfully good people, especially technicians and specialists, aged 38 to 42 years old, retire right at a time when their knowledge and experience are at a prime. I believe that we should structure our pay, benefits, and retirement system to keep them in longer, did either one of your organizations studies address the concerns that I have expressed, if we are going to spend considerable sums of money on manpower, how do we best spend it to keep people in the service rather than to encourage them to leave, as I am afraid too much of our present retirement system does?

Mr. HALE. Yes, we tried to estimate the effects on retention that these plans would have, Senator. We looked at the overall career force—those with over 4 years of service. We estimated that in the long run—and it would take a while—but in the long run you would have about a 3-percent smaller career force than under the current system. You are going to give less in benefits, so a few more people are going to leave the service.

If you are thinking specifically of those with more than 20 years of service, the DOD plan is not likely to result in a larger percent than, say, the current one. For those who actually stay 20 years, they are more likely to remain beyond 20 years. But, because overall the plan is somewhat less generous, you are going to have some more losses back around the 10- to 12-year point, and those people will not ever get to 20 years of service. The net effect of those two changes is that you are likely to have a slightly smaller percentage than the force that stays beyond 20 years under the DOD plans than under the current system.

Does that make sense?

Senator EXON. Yes, it does. I assume maybe you are going to say it is a wash.

Mr. HALE. No, probably not. The DOD actually estimates quite substantial losses, but once again I am concerned about their choice of the base, the 1976–82 period.

I think if you use more current retention as a base you would find the career force beyond 20 years of service would be slightly

similar but not dramatically; in fact, maybe 5 percent or so smaller.

Senator EXON. Do you have any comment?

Mr. FERBER. We did a different cut of DOD's assessment using some sensitivity analysis on some factors that are key to individual decisionmaking. Coincidentally, we came up with about the same figure as CBO's analysis.

I might just add that, while not part of this analysis, it is our opinion that you have to look at retirement pay as well as all aspects of compensation as a force management tool.

If we were designing a system, we would have provisions where you would keep the kind of people that you actually need well beyond 20 years. We would also advocate the earlier vesting aspect of all the prior studies where there are some people that you would want to let go earlier.

We would like to see a much broader range of management options, management tools, than the all or nothing aspect of this 20 years. That is not something we are prepared to quantify today, but it is something we plan to be looking at in the future.

Senator EXON. Thank you, gentlemen. Thank you, Mr. Chairman. I came out of the business world and I know that no business could plan a retirement program that did not progressively move up; while the longer you stay, the more you get and the more reason for you to stay until you get to an age where you no longer fit into the program.

I guess that the Retirement Program and the way we have structured them over the years, in my opinion, is not very conducive to keeping what I refer to as that master sergeant or petty officer who is the best man in the company or squadron or work center. When he gets to be 40 or 42 years old, there is almost every incentive for him, I am afraid, to go and work for United Airlines rather than to stay in the service.

Recognizing that the military is not a business, I still think we can take a more businesslike approach. I do not think we have used enough of the business principles to try and go through the expensive training of people, then keeping them in. I think, therefore, we have to be more selective and make some changes in the retirement system which the military would rather prefer to leave as is.

Thank you very much, and thank you, Mr. Chairman, for your courtesy.

Senator WILSON. You are entirely welcome, Senator Exon.

To pick up on a point that the Senator has raised, let us inquire—I have not gone through all of the prior options of the fifth quad and the other efforts. I have forgotten where it is in your presentation, Mr. Ferber, or in Mr. Hale's, but one place or the other, the point has been made that in making out fitness reports, superiors in the military are sometimes reluctant or would be reluctant if they had the opportunity to let people go prior to the 20 years because they are not covered by benefits. There is no vesting until the 20-year point.

I do not know how you would go about attempting to quantify the costs if we were to do something in the way of graduated benefits, which is in part proposed by the simple two-step modification

that is involved in these DOD proposals where, after 20, the effort is made to retain people further by increasing the multiplier.

You can quantify that, and if we had some specific numbers as to, let us say, what the multiplier would be if we allow vesting after 8 years or 12 and a much smaller multiplier and then graduating on up, it would obviously cost something that it is not costing us now, but we might—it would be interesting to see what the effect of that would be.

Has work been done in that area?

Mr. HALE. Yes. We have not done it recently. As Mr. Ferber said, all of the past studies except the fifth QRMC recommended early vesting usually at the 10-year point, some as early as 5. We have costed out a number of those plans.

What they would do, Mr. Chairman, is give a little bit more draw at around the first reenlistment point, because now the person could get some benefits with as few as, say, 10 years of service. There is a little bit more incentive to stay in. Of course, once you get to 10 years, there is more incentive to get out, because now you can get something even if you leave.

The result would probably be a pattern with a somewhat higher proportion of journeyman personnel in for 4 to 10 years, and probably a somewhat lower proportion in the 10 years and beyond range. I think it is important that you think about it in those terms. Do you want that kind of change in the force profile as well as the dollar effects?

Senator WILSON. Mr. Ferber, you indicated that it would be 8 to 10 years before a change made today would have a real impact and become evident, you have also indicated why.

Therefore, if Congress in connection with the Department decided to avert some of this loss by the kinds of options that we have been discussing here, the various reenlistment bonuses, at what point is it necessary to take action of that kind in order to prevent those losses from occurring?

Mr. FERBER. Well, Mr. Chairman, I think managing the force is a continuing process of which retirement is just one aspect of total compensation that has to be considered in terms of what your force management needs are.

If retention is a problem, you have retention reenlistment bonuses, across-the-board pay increases. Some of those have been used in the past, as Mr. Hale pointed out, some are cost effective compared to retirement.

Senator WILSON. It is both yours and CBO's overall conclusions, that you could make some structural changes to the overall compensation system and increase the effectiveness of that system as a force management tool so that you could retain people and make some savings in the bargain?

Mr. FERBER. Yes, but what exactly you do is the problem facing us. We have long advocated that you have to look at the total compensation package, looking at what impact changing one has to do on the other.

This is not being done today. DOD's total compensation study, which they are starting next year, is a good start, but it is a very complex system with a lot of interrelationships of pay, allowances, and benefits that have to be evaluated.

In that regard, we are coming out with a staff study in the next 2 or 3 weeks that lays out all the different aspects of military compensation and all the issues that have to be addressed and the interrelations.

Part of that study does respond to a concern that has been raised by this subcommittee in the past on the need for pay principles upon which to guide any changes in total compensation. That study will just raise questions, and we hope lay a foundation for some quantitative analyses on the various aspects of compensation.

Senator WILSON. I cannot quarrel with your premise, and I do not think any of us do. In fact, the other day Senator Glenn made a point that when he was first in the service and for sometime thereafter, the actual basic pay or the regular military compensation was not competitive, plainly not competitive with the civilian sector.

Over a period of time, the concerted effort by Congress has redressed that which is, I think, a very interesting point and a relevant one as we consider some reform in the retirement system because, as he also pointed out and as I think we had all recognized, the retirement that was given at that point was clearly an incentive, an inducement to a lot of people who rightly thought they were being underpaid for service to their country who could have been commanding much higher compensation in the private sector.

Retirement at that stage amounts to deferred compensation, and I have heard many of the service personnel chiefs so describe it to this day, saying that what we are really doing is retaining people of quality with a system that exceeds normal civilian retirement plans, but should because it really is more than retirement. It is deferred compensation.

The question arises, have we sufficiently redressed the regular military compensation to the point that that argument is no longer valid?

Mr. FERBER. Well, we have done over the last couple of years a body of work for the Senate Appropriations Committee which we are in fact updating right now, which compares disposable income of the military to Federal civilians.

When I say disposable income, it looks at regular military compensation which includes some allowances that are tax free. You have to then add in the tax advantage. This is exactly the way DOD assesses it, also.

Maybe a couple of comparisons that we had in our last report which was issued in March leads one to believe that military pay is pretty comparable, at least with Federal civil service. A two-star general makes more than a Cabinet head. A lieutenant colonel makes the same as a GS–15, and an E–7 makes the same amount of pay as a GS–11, and I would argue that those are comparable.

Mr. HALE. Mr. Chairman, I would urge that, although we have to do those kinds of comparisons ourselves and they are useful to help you think about how things are going, we should fundamentally rely on how we are doing in getting and keeping the people we need.

Right now, fortunately, we are doing well. Recruiting quality is quite high; we are meeting numerical goals. And retention is quite high. In some cases, there is even an indication that some of the

services may be wondering whether they want larger career forces, in the Army in particular.

I think that is the fundamental criterion that you ought to apply to figure out whether or not the total package of pay is right; then you have the hard job of judging whether or not you could slim down on some aspects of it, like retirement, and accept what would be some degradation in retention.

Senator WILSON. Mr. Ferber—first, let me comment that your explanation of the workings as the annualized cost of leaving model, the ACOL model, is I think perhaps the best explanation of that model that I have seen.

Let me ask you this. Is it true that the ACOL model is—assuming that it is really the best model that we have to date to try to predict long-term effects of changes in the overall compensation system and the retirement system specifically—it is also true that the model has never been asked to predict effects of compensation changes of the nature that are addressed in the Department's proposals?

Mr. FERBER. Well, first, thank you for your comment.

I think I would like to turn to Dr. McNaught, who basically did our analysis of the ACOL model.

Mr. MCNAUGHT. Mr. Chairman——

Senator WILSON. I thought he might have something to do with that. I saw him smile when I said that.

Mr. MCNAUGHT. Mr. Chairman, the model was in fact developed in the President's Commission on Military Compensation to do precisely these kinds of studies and has been used in the past to estimate retention impacts of retirement changes of the like that we are talking about today.

What has not happened is any assessment of its prediction being made, because it takes so long for us to observe any retention changes due to retirement change. Marty has already mentioned the 8 hours. That does not mean that the model has not been verified, though.

It has been used to predict changes in base pay and changes in retention due to reenlistment bonuses, and it has proven pretty accurate in those applications.

I think the judgment of the economic fraternity would be that it is a pretty useful model for doing this kind of research.

Senator WILSON. Are you satified, Dr. McNaught, that the model is sufficient to changes so that as the economy makes great changes—and God knows that we have been through turbulent changing times in terms of unemployment—that it can be kept current, and those changes allows for a real world and real time predictions?

The difficulty you have, of course, is that in order to make the kind of prediction I would like to see, I would ask you what would happen if we make these changes as proposed by the Department, and will we be in a recession at that time, or will times be good and we will have a tough time competing with the private sector?

Mr. MCNAUGHT. If you are asking for precise predictions, I do not have to tell you the difficulty of getting precise predictions out of the fraternity, but is the model being kept current? Not only is it being kept current, but is it being developed by a number of re-

searchers, CBO and us and the Department itself. It is under continual study.

Senator WILSON. Well, seriously, what do you do to try to look at what the economy will be, because I think all of you have stated that clearly the economy has an enormous impact on both recruitment and retention.

When times are bad, recruitment improves, retention improves, and the converse has also proven true.

Mr. MCNAUGHT. When we do these kinds of estimates, we presume some sort of longrun average state of the economy. Certainly, retention is going to vary quite a bit when the economy varies, but I do not advocate changing retirement when times get bad.

You just cannot make those kinds of structural changes on a short-term basis. To me, trying to adjust—to use models like this to adjust economic fluctuations is a strong argument for using more flexible tools like reenlistment bonuses that you can increase and decrease and are not seen as part of the permanent compensation package by most of the enlisted force.

Senator WILSON. Well, that really was the point of my question. One of the things I think we really need to know is how important is the current economic situation as a determinant in our ability to recruit and retain, and do we therefore serve ourselves better in terms of the overall management system to provide the flexibility that you are talking about?

I gather your response is yes.

Mr. FERBER. Mr. Chairman, I might make a comment on that. In the report that the Department of Defense sent to the House Armed Services Committee last year, one of the variables that was analyzed in terms of its effect on retention was military-civilian wage differentials.

The report to the House Armed Services Committee indicates that economic conditions, that is the employment rate, would be more important in terms of reenlistment than the civilian-military wage differentials, part of which would be due to the retirement annuity.

Senator WILSON. Thank you. Senator Glenn?

Senator GLENN. Thank you, Mr. Chairman. I was going to get into that same area, too, and I am interested in following it just a little bit further than this because if we happen to get into an economic cycle where we have either a 10-year down trend or, say, a 10-year up trend, we are going to be faced with what kind of people are getting into the military as a result of that.

That may make a decided difference in the capability of the military for a very long period of time. I appreciate the fact that it is difficult to predict this. You are looking for the long-term trends and sort of evening out, in your approach to this thing, the economic cycles and taking the approach that what we do should be for the long haul.

I agree with that, but I think some of these things, some of the economic cycles that we get into may be long enough themselves that we could wind up with better or lesser people in the military that would affect their overall capability, if you follow that.

Mr. MCNAUGHT. Yes, sir.

Senator GLENN. Do any of the models that any of you use right now really take into effect the economic cycles? I know you are working on it, but do any of them that you actually are giving figures to us on now take into effect the economic cycles?

For instance, the figures DOD used, you cited the 1976 to 1982 period. That is not necessarily a typical period, and yet they used that. I think it was to their advantage to use that. Maybe 1 or 2 years they should have knocked out in the middle, there, if they really wanted to skew the figures around a little bit more. That was not exactly a typical period as I see it.

Did any of you use, say, a 15-year period just before 1976 where there were some varying rates, and after 1982 there were some high rates?

Mr. HALE. What we have done in all the numbers we have presented to you, Senator Glenn, is to take recent behavior, 1983 and 1984, and adjust it for what we would expect to happen because of unemployment. That is our baseline.

Remember, we are giving you steady state or longrun projections here. We can do time-phased projections. They depend not only on military retirement but also on our forecast of the economy, and we at CBO pray a lot when we make those forecasts. If we pass Gramm-Rudman, I think we will pray even more.

We can do those projections. But we have not done them in the material we have presented to you because, I think, as Dr. McNaught said——

Senator GLENN. Can I quote you as being opposed to Gramm-Rudman at this point?

Mr. HALE. No, sir. As Dr. McNaught said, retirement is a long-term program, and I think you want to look at it in the long run. If you face near-term problems, adjust things that you can adjust more easily than retirement—reenlistment bonuses for example.

Senator GLENN. Mr. Ferber, you take the position in your statement that because the legislation to change the retirement system has not been enacted, that DOD is in a funding deficiency position because the $2.9 billion reduction to retirement accrual costs in the fiscal 1986 budget, correct?

Mr. FERBER. They will be.

Senator GLENN. Is it GAO's position that DOD should begin taking steps now to live within the reduced funding level in the military personnel accounts in the event Congress does not enact changes to the military retirement system?

Mr. FERBER. From a legal standpoint, they are not in violation until much later in the year. Now, soon, they would have to take steps to avoid being in an antideficiency position then. The law says that by the end of the year they would be in violation of the Anti-Deficiency Act.

There is a GAO Comptroller General opinion that when dire consequences of making a funding change are predicted, that agency should not wait until the end of the year to take appropriate actions. That also would put them in violation of the antideficiency statute.

Senator GLENN. Well, every year DOD operates for the first half of the year in a deficiency position with regard to military personnel accounts anyway.

Mr. FERBER. There is an exception in the Anti-Deficiency Act that allows an agency to keep spending knowing that there might be an increase in pay, so that is a specific exception to the antideficiency statute.

Senator GLENN. Our fiscal year starts in October, of course, and we do not normally get around to that supplemental that gives the annual pay increase or whatever until in the spring sometime, so it is way, way late in the year.

Are you being consistent when GAO says that we will hold their feet to the fire in one instance but we let them get away with much bigger deficiencies in another area?

Mr. FERBER. We are consistent in reading the law. The law specifically exempts the pay increases from antideficiency. There is no such exemption for the change to the accrual that we are talking about today.

Senator GLENN. OK.

Mr. Hale, has CBO done any analysis of the effects if we go through with the $2.9 billion proposal, one proposal or the other? Have you done any study on the impact of that on individual services? What I am thinking about would be the impact of the proposals.

Would they be more severe, for instance, on the Marine Corps with a smaller percentage of their force in the 10- to 20-year years of service bracket than the Air Force, which has a higher percentage of force in the 10 to 20 years of service bracket?

It seems to me there might be some different effects here that we might consider.

Mr. HALE. We have not focused on that in our analysis. It multiplies by four the amount of work, and we did not have time. From past work I can tell you that in general the Navy will tend to be more responsive to pay changes and, therefore, may be affected by a higher-than-average amount; the Air Force probably less than the average. Typically, the Army and Marine Corps would be affected at about the average level.

I do not want to overstate the precision of these findings. They give you a general idea. We have not focused on individual services in this analysis.

Senator GLENN. I asked each person here yesterday and Senator Simon earlier today about any research there is and what steps should be taken in other areas of military compensation, bonuses or continuation pay to offset any negative retention impact or changes to the military retirement system.

Have you looked into those and calculated what the impact of different retention benefits might be?

Mr. HALE. Again, we have not done it for the specific plans, but I think I can go back to the past work and give you an idea.

Senator GLENN. You were here when I commented on the education aspects of this before. Education benefits tend to get people out, not in. They may get the men in recruitment to begin with, but they then tend to get them out at a time you would like to keep them.

Mr. HALE. If you were to offset the retention losses of the DOD plans by, say, increasing reenlistment bonuses, targeting particularly on the groups with whom you were most concerned, I think

past work suggests that it might offset perhaps 10 percent to 25 percent of the savings, so instead of $2.9 billion you might be talking about savings of $2 billion to $2.5 billion. If you were to offset those potential losses——

Senator GLENN. Two to two and a half billion?

Mr. HALE. Perhaps. In the long run, again, we are talking about accrual savings, so we have to look at the long run. If you were to offset those retention losses by increasing basic pay across the board, then you would offset more of the savings. I do not have a number for you, but it would probably offset substantially more than a quarter of the savings potential.

Senator GLENN. You say in your statement the career force losses under the two DOD plans, and I quote, "would total approximately 3 percent, leading to annual accession increases of 3 percent in order to maintain constant end strengths."

In your view, will this 3-percent increase in accession recruitments create a significant problem for the services' recruiting commands? It seems to me that we are going to save some money in some areas and maybe have some additional expenses in others.

Mr. HALE. There would be some added costs. We tried to estimate those. We looked at the effects on outlays. The outlays would go up for accession and training costs, but there would be some offsetting reductions because we have a more junior force, and so the pay bill would go down a little bit.

The net effect, as I said in my testimony, is that for the first decade the outlays would go up about $10 million to $20 million a year, primarily because of those accession and training costs. That is a tiny fraction of the total pay bill.

Beginning in the second decade, you would begin to get some net savings, and of course about 20 years after enactment you would begin to realize some substantial outlay savings.

The short answer is yes, the costs would increase, but I do not think they would be more than a tiny fraction of the total pay bill.

Senator GLENN. One other question. You commented earlier on some very specific elements of Senator Simon's plan. I understand CBO has done an analysis of those proposals in toto to change our military retirement system.

Can you tell us what the results of that analysis are in more broad terms than you did before?

Mr. HALE. In general, Senator Simon presented them to you. We found that there would be accrual savings, calculated on the same basis as the $2.9 billion, of about $10 billion in 1986 if you implemented the plan right now. In the long run you would see about a 7-percent smaller career force, that is those with more than 4 years of service, than you would have under the current system.

I would add a qualitative statement, in that I think Senator Simon's plan is clearly more far-reaching and, therefore, it is somewhat riskier. It is much harder for us to analyze a plan that is fundamentally different than the current system.

For example, in Senator Simon's case he prohibits all retirement benefits until 25 years of service. It is hard to know how people will react to that. So I think that both from a modeling standpoint and from your standpoint in assessing it, you have to look not only

at the numbers but realize there is probably a higher risk associated with the Simon plan than the DOD plan.

Senator GLENN. Does anyone else want to comment on that?

Mr. FERBER. Not on the Simon proposal, but back to the first part of your question on recruitment, I will turn it over to Dr. Harper. Coincidentally, we just picked up Maj. Gen. Keith McCartney [USAF, retired] as a consultant, who used to head the Air Force Recruiting Command, and specifically yesterday we talked to him about what would you need to do to increase accessions if retention posed a problem.

Mr. HARPER. Senator, I chatted with him about what types of actions the Department might take that would be relatively costless in terms of increased recruiting. He relayed a number of stories about the types of things that he had done when he took over the Recruiting Command in some very tough years, in 1979 and 1980, and that the Department can do in the way of different management styles, different command emphasis, different types of concerns with getting the job done within the resources available that indicated there are perhaps some alternatives to additional expenditures to overcome recruiting and retention.

Senator GLENN. What are the specifics?

Mr. HARPER. He talked about asking whether youth who were mental category one, high school graduates, the upper mental category people that the military are anxious to have, had to meet certain weight requirements, when they are recruited, or do they have to meet those weight requirements when they come out of basic training.

It was possible for him to bring in 10,000 extra high quality recruits by taking the 5 pounds off at basic training.

Senator GLENN. Run their tails off in basic training.

Mr. HARPER. That is right.

Senator GLENN. What else? I doubt that we are going to make up our armed services out of fatties who we are going to skinny down, but go ahead.

Mr. HARPER. He talked about what some people refer to as the Pygmalion effect, that is you act as you believe reality is, so that when he stepped into the Recruiting Command there was a sense that they were going to be short in their goals, and when he went out and talked to the recruiters they were preparing to be short on their goals, and he told them, gentlemen, there is no way we are going to be short at the end of this year.

They came up short, but very much less short than the goals or projections had been.

Senator GLENN. Maybe so. A positive attitude is one thing in the Recruiting Command, but a positive attitude is not going to get you your people in good times when other jobs are available and things like that, I would presume.

I made a joke out of the weight thing, but you cannot base your recruiting program on getting the heavyweights in and slimming them down. You really cannot, if that was a serious proposal.

That and an attitude change of recruiters, those two things are hardly going to make the difference. Did he have any other things on structural changes or management styles to suggest?

Mr. HARPER. I do not recall specifically, but from discussions of the change in emphasis at the Army Recruiting Command at about the same time, I would believe those would have a very positive effect, Senator.

Senator GLENN. Well, some of them would, I am sure.

As you get on with these models of recruiting and retention that match up better with good and bad economic times, I would be interested in what we could do there. Maybe we need a countercyclical approach to this kind of thing, where in good times we have certain incentives and bad times others.

It has been my observation in the military that your ease of recruiting and retention was absolutely directly hooked up with whether you are having good times or bad times on the outside, and that was shown over the last few years.

I think in 1982 and 1983, they did not know what to do with all the people volunteering because they could not get jobs any place else, and we could not have had a recruiting service. They would have been finding ways to get in the service. We had not had a recruiting service out there almost, because it was a place to get a job.

It was so easy that the people at the recruiting service were getting pretty sloppy, as a matter of fact. They did not have to have much incentive, and now it is a little tougher; so it goes up and down just directly opposite.

It is countercyclical to what the situation is. Whether we are having good economic times or bad economic times, the reverse is true on good and bad recruiting and retention. I think that is a bigger factor than almost anything else from my observation.

Now, long term, I agree. Long term you want to be fair with the people. You want to set up a fair system, but I do not know how you take in this economic cycle effect. There ought to be some way to do it in your econometric modeling.

Thank you, Mr. Chairman. I do not know; maybe you want to make a comment on that.

Mr. HALE. The model we are using attempts to account for unemployment. I would not claim that we are perfect, but we make an attempt. In the long-run estimates that we have given you, we have, in a sense factored it out by assuming that unemployment stays roughly at today's levels.

Senator WILSON. Mr. Ferber, you have addressed in your testimony the possibility of responding to the immediate financial exigency by a drawdown on personnel.

Let me make clear, I am hardly suggesting such action. I think it is our responsibility to see to it that the Department avoids it. Can you describe a possible scenario involving a drawdown of personnel if Congress does not enact changes to the military retirement system?

Mr. FERBER. Yes, Mr. Chairman. DOD has estimated what the drawdown schedule would be until or if they were not granted legislative relief.

As of December 1, just a few days ago, they would have had to have reduced the Active Force by 165,000 and the Reserve Force by 88,000. This grows monthly until the legislation or at least the relief is granted.

Senator WILSON. 165,000?

Mr. FERBER. As of December 1, DOD's estimate is that they would have had to reduce the Active Force by 165,000 and the Reserve Force by 88,000, and then this grows monthly if relief is not granted, that is the figure they would have to draw down the force by in order to meet the antideficiency provisions.

Senator WILSON. Substantially larger than anything we have talked about as a result of changes.

Mr. FERBER. Yes, sir.

Senator WILSON. Senator Thurmond?

Senator THURMOND. I want to thank you gentlemen for coming and the contribution you are making here. I shall make it a point to study your testimony more carefully.

You have answered questions, I presume, on the two systems that the military department sent down. I believe they recommend no change, but there is a change that recommends these two be considered.

Has that been your testimony on those?

Mr. FERBER. Yes.

Mr. HALE. Yes. We have analyzed those two systems.

Senator THURMOND. Have you expressed any independent opinon otherwise?

Mr. HALE. Well, Senator Thurmond——

Senator THURMOND. In other words, what is best for the military? What is best for this country?

Mr. HALE. I am not in a position to answer that as an employee of the Congressional Budget Office. I can tell you that you face a choice. You can save some money in the long run, around $3 billion a year eventually.

Senator THURMOND. How much?

Mr. HALE. Eventually $3 billion a year. It would grow to that over time. In return, you would get a modestly smaller career force defined as those with more than 4 years of service, about 3 percent less than you would have otherwise had. The choice you will ultimately have to make is whether or not those savings are worthwhile in the face of that sort of degradation in the career force.

Senator THURMOND. You do not have any plan that you have come up with on your own that you feel would be better than either one of these plans?

Mr. HALE. No. CBO does not have an alternative to propose to you that we think is obviously superior.

Senator THURMOND. These retirements are getting extremely expensive, not only in the military but for the civilians, too. The question is, What can we do about it?

We have got to do something some way, and of course a lot of people feel that we just ought not to give any COLA's until we balance this budget. Frankly, that would be my opinion.

I do not see why Congress or anybody else should be getting an increase until we balance this budget. The budget is keeping interest rates high, and it is holding back the economy. It is keeping the dollar high, and it hurts everybody.

We will all be better off if we can get this budget balanced, and there are a lot of things to be done. That is one thing a great many people feel we ought to do, and we could do that without cutting

anybody back. Just do not give any increases in the form of the COLA's until we do get this budget balanced.

Have you thought about that any?

Mr. HALE. Yes. We have looked at that alternative in as many ways as you can probably think of; Social Security in and out, different options for civil service and military retirement. It does yield very substantial savings over time, particularly if you include Social Security.

COLA freezes do not cut people's benefits back relative to today's levels. But they do reduce the real value of retirement, the amount of things people can buy with their retired pay, and as such, it is a reduction in benefits and would lead to——

Senator THURMOND. In order to get this budget balanced, pay may have to sacrifice. We all may have to sacrifice some, and would it not be worth sacrificing if we can get this budget balanced, and then where we can bring the interest rate down and not be placing this heavy burden on the next generation and generations to come which we are doing now?

I mean, that is what disturbs me. A $2 trillion deficit; it just does not make sense. If Congress is going to spend this money, they ought to have the courage to put on a tax to pay it.

I think there has got to be some reductions in this spending, and it may eventually have to be some increases in some kind of taxes to supplement that, because I think this budget has got to be balanced.

We have balanced it once in 25 years. How long would you stay in business if you used up more than you take in for 10 years? You could not do it, could you?

Mr. HALE. Not long, I suspect.

Senator THURMOND. No corporation can do it, either. This Government cannot keep on doing it.

Thank you, Mr. Chairman.

Senator WILSON. Thank you, Senator Thurmond.

Mr. Hale, you noted differences between the CBO and the Department figures concerning the effects on the career force of these proposed changes, and you assigned that to the difference in the period of retention that they have looked at, the 1976–82.

All right, I think that is perfectly valid. That, in their defense, was a period that they were instructed to use.

Mr. HALE. They were instructed to use the fifth QRMC methodology.

Senator WILSON. That is right, and that is the reason why, in order to make it fit with the fifth quad analysis.

It is your estimate that a loss of 27,000 to 34,000 career personnel will occur under the Department's proposals. Could you be specific as to how those losses will occur? That is to say, how long, if there are no midstream corrections made, would it be before we begin to feel that and reach the total?

Mr. HALE. Let me leave aside the issue for a moment of whether there would be any effects on people who are grandfathered, whose pay is not changed. I will come back to that.

But assuming no effects on grandfathered personnel, I would not expect to see any significant changes for several years. I would see them beginning perhaps 4 years after enactment and building up

gradually after that. I would expect you to see most of the longrun effects within 10 to 15 years after enactment of the legislation.

Now, there is the issue that the Department of Defense has raised—that there may be some immediate effects on those who are grandfathered and therefore experience no change in pay. We do not have any analytic reason for assuming that this is true. Their pay will not be changed, and so as analysts we have no basis to predict that they would change their behavior.

It is possible that morale would be adversely affected, but I would hope that if the Department of Defense managed this and made clear to people now on active duty that the Government is keeping faith and not changing whatever implicit contract now exists, that those changes in morale would be minimal.

Senator WILSON. I concur in your judgment. I think that should be the case, provided that it is made clear, as I hope we have here, that it will not be any kind of a retroactive change.

Mr. Hale, you indicated that because of an accounting change that will occur next year in the accrual accounting system, the savings that would result from the enactment of either of the Department's proposals would be only about $500 million in fiscal year 1987.

In fiscal year 1986, the accrual charge under existing law is approximately $18 billion. If no change in retirement entitlement is enacted this year, what would the accrual charge be in fiscal year 1987, if the law continues as it now exists?

Mr. HALE. The DOD Actuary is constantly reviewing its procedures and has proposed some changes that would modestly increase the charge. It is calculated as a percentage of basic pay. It is set at 50.7 percent in 1986, and I believe it will go up to 51.7 percent in 1987, so the amount would be modestly higher if there were no change in retirement. And of course it will go up because of the pay raises. I do not have a figure off the top of my head, but it will probably be in the high $18 billions.

Senator WILSON. If we were to wait until fiscal year 1987 to enact one of the two proposals from the Department of Defense, what would the reduction be to the accrual charge?

Mr. HALE. Under the accounting procedure that would be in effect then, it would be $200 million to $300 million, because they will apply it only to 1 year's worth of people; that is, only the ones you have not grandfathered. That is why it is so much smaller, whereas right now we are essentially applying it to everybody.

Senator WILSON. I again commend you on the testimony that both of your offices have produced this afternoon. Throughout this entire set of hearings, yesterday and today, we have been concerned with numbers because we are compelled to be. We are concerned with force management and the use of compensation to bring about the desired profile.

There is underlying all of that, or I should say running through it, a question of fairness, and that may be a little bit outside the normal ambit of requirements placed on you. Understanding that there are certain constraints from a policy point of view, I would invite both offices, both of you, Mr. Ferber and Mr. Hale and Mr. Singer and Dr. McNaught and Dr. Harper—you spent a great deal of time on the subject of compensation.

In your efforts to analyze what the impacts of various changes and options might be, you are relying on econometric models, on ACOL. I am just wondering how much the question of fairness seems to be a factor in what you have determined to be responses as you have attempted to apply on these different models all of the permutations that have been suggested by the fifth quad and its predecessors?

It is a question that I think necessarily has to trouble us because we are concerned with an effort to both achieve the kind of force that the country's security demands and yet live within the limits of the budget. Senator Thurmond has been eloquent on that point.

Is there a particular approach to compensation or to a package of compensation that has seemed to you in your studies of this to possess a greater fairness from the standpoint of the personnel, both in their response to it and any objective criteria that you would attach to that judgment?

Mr. HALE. I think so. I think that we need a package of compensation of both deferred retirement and active duty pay that allows the military to get and keep the people they need. At the same time, if it does that and people get to make choices freely in the marketplace, that seems to me it guarantees them fairness as well. If it is not fair to them, they will not come into the military.

At the same time, it has to be roughly the minimum costs needed to recruit and retain the people, to be fair to the taxpayers. That leads us always back to the notion of telling you that, yes, you can save some money but you are going to give something up. Yes, you can save $2.9 billion a year in the long run, but you are going to have a smaller career force. Unfortunately, though not for me, I have to leave to you the hard judgment of whether or not that is a trade that is reasonable for the military.

But I think the philosophy guiding that hard choice ought to be that you should pay no more than you have to to attract and retain the people you need. It seems to me that would lead to fairness for both the taxpayer and the military people.

Senator WILSON. Another point that I do not know we have time to talk on sufficiently, since we have been concerned with numbers both in terms of dollars and force strength, but in addition to quantity I would like to talk to you for a moment about quality.

The thought that either of these proposals would result in a reduction in force strength of something like 3 percent over time, I must admit that I do not find enormously alarming, particularly because I think there are ways that we could reverse that if, not looking at the 3 percent but looking at a change in circumstance that would certainly dictate the need for expansion of force strength.

Is there, in your judgment, from what you have determined in both your analysis of the DOD proposals pending before this subcommittee and any prior studies of compensation, is there an effect upon quality that is taken?

In other words, if we are going to lose 3 percent, are we losing the best 3 percent, or are we likely to retain the best because from the standpoint of what we are looking for, we are looking for people who are guided primarily by their desire to serve in the

military because they like the life and are less concerned with compensation?

That is the qualitative aspect.

Mr. HALE. That is a hard question to answer. On the retention side, in the career force, as I was just talking with Neil, we do not really have an independent measure of quality, and I am not sure what it would be.

All of these people are trained. They have been allowed to reenlist at least once. You would hope all of them at least meet some minimum level, although clearly some are going to be better than others.

I do not think we are able to measure that well. If you judge that the percentage degradation is modest, I do not think there is any reason to believe that there would be a disproportionately large number of the best people—whatever that means—who would leave.

On the recruit side we do have measures. They may be flawed, but we use them all the time; high school graduates, mental category and the like. By increasing the numbers of people we need, all else being equal, you are going to slightly decrease the quality. We are going to need in the long run, years from now, 3 percent more recruits. All else being equal, you will get the modest degradation, 3 percent or so, in quality. Again, that is the judgment you get to make—whether that is something you can live with.

Senator WILSON. I think we would be interested in any information that you have that applies that to—not only particular services but particular military occupational specialties.

Mr. HALE. We could comment on the services for you. I think we are even less able—and Neil, do you want to add to that—to comment on specialties. The more we disagree, the harder it is because, for one thing, the errors are more important in smaller groups, and we know less in many cases, so I am not sure we could comment on specialties.

Mr. SINGER. Senator, I think the only point that I would offer on this score is that the kinds of fluctuations we are talking about with respect to recruit quality, as well as with respect to career force retention, are not large in comparison with what we have seen in the normal course of business in recent years.

As John Harper pointed out, there is a lot of anecdotal evidence that supports the proposition that by changing the way they manage their recruiting function, the services can also change the success of that function. I think that within the kinds of fluctuations, 3 percent in terms of accession numbers, it would be pretty risky business to predict with any real confidence that there would be systematic changes in recruit quality.

I think that by and large, the services would be able to compensate for those additional requirements at minimal cost.

Mr. FERBER. I might add that when the services target their reenlistment bonuses by the different specialties, MOS's that they need, that gets at part of the problem.

We have done work in the past which shows they can do a much better job of retaining the quality when they target those reenlistment bonuses, too. It is basically across the board if you are willing to reup in the MOS.

You can take a cut of quality in that, too, and get more efficiency for the dollars that you do target.

Senator WILSON. Well, gentlemen, we thank you. It has been most instructive and very helpful. As you put it so eloquently, Mr. Hale, now you leave the hard part to us.

With that, this hearing is adjourned. Thank you.

[Whereupon, at 3:48 p.m., the subcommittee adjourned, to reconvene upon call of the Chair.]

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